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MICHAEL RODAK, JR., CLE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73— **73-880**

THE LIONEL CORPORATION,
Petitioner,

against

REPUBLIC TECHNOLOGY FUND, INC.,
Respondent.

THE LIONEL CORPORATION,
Petitioner,

against

THE NEW ENGLAND INDUSTRIES, INC.
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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December 5, 1973

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Petitioner, The Lionel Corporation, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit. The court affirmed in part and reversed in part a judgment after bench trial (Bonsal, D.J.) dismissing respondents' complaints, and remanded the case to the trial court.

Opinions Below

The opinion and concurring opinion of the court below are reported at 483 F.2d 540, 553 (2d Cir. 1973). The opinion of the trial court is reported at 345 F. Supp. 656 (S.D.N.Y. 1972). Both opinions are appended to this petition.

Jurisdiction

The judgment of the court below was entered July 17, 1973, and its denial of Lionel's timely petition for rehearing and rehearing *in banc* was entered September 6, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented

Whether an appellate court may usurp the role of the trial court, and in its independent fact-finding, go beyond the record, make findings inconsistent with and contradicted by the record, redefine the issue, and unjustly relieve respondents of their burden of proof.

This Court should, for the benefit of Bench and Bar, restore meaning and force to the mandate of Rule 52(a) of the Federal Rules of Civil Procedure that findings of fact shall not be set aside unless "clearly erroneous." Since the court below shockingly abused its appellate function and, in usurping the role of the trial court in our judicial system, committed plain error, this Court should in accordance with its power of supervision of the federal judiciary, reinstate the trial court decision, which was amply supported by the evidence.

This Court should hear this case not only because of the important issue raised but also because these parties have litigated for over a decade about financial statements which are now more than twelve years old, and Lionel's position, if sustained, would render further proceedings unnecessary. To be remanded to the trial court for further proceedings on the basis of findings "as a matter of law" which are palpably inaccurate is a miscarriage of justice.

Statutes and Rules Involved

The Rules involved in this petition are Rule 52(a) of the Federal Rules of Civil Procedure, and the last clause of Supreme Court Rule 19(1)(b). Rule 52(a) provides in pertinent part:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, the statutes involved in this case, are not relevant to the issues raised in this petition.

Statement of the Case

In November 1961, Hathaway Instruments, Inc. was merged into Lionel. This lawsuit concerns the unaudited, interim financial statements of Lionel for the period ending June 30, 1961 appearing in the Hathaway Proxy Statement, which allegedly misled respondents, two Hathaway shareholders, to exchange their unregistered Hathaway stock for Lionel stock pursuant to a Merger Agreement.

Respondents claim damages for (a) violations of antifraud provisions of the securities acts of 1933 and 1934 and (b) breach of contractual obligations with respect to registration of the Lionel stock received upon the merger. Lionel's contractual obligations were to file a Registration Statement including respondents' shares by October 15, 1961, and to use best efforts to secure and maintain its effectiveness for a period of twenty-four months.

The Lionel financial statements of June 30, 1961 are at the heart of both claims, since it is contended that misleading financials affected the registration.

Ten years passed before this case came to trial. Respondents first brought an action against Lionel in April 1963, claiming they suffered $185,000 in damages by reason of the allegedly misleading interim financials and breach of registration obligations. That action was dismissed in May 1966 for complete lack of prosecution. Respondents then commenced the present actions, based on the same contentions, now seeking approximately $1.5 million in damages. Through discovery, respondents had access to the books, records and personnel of Lionel and S.D. Leidesdorf & Co., a firm of certified public accountants which served as Lionel's outside, independent auditors. Numerous depositions were taken. Leidesdorf permitted respondents to inspect its relevant files on the Leidesdorf premises, and respondents' retained accountant studied the Leidesdorf records on a number of occasions over a period of months.

Respondents themselves, who were described by their counsel as sophisticated in the stock market, never appeared at the trial. There was no evidence that they even saw the disputed financials. Their case was presented entirely through counsel and two retained witnesses, an accountant (but not the accountant who had examined Leidesdorf's records on its premises) as to the financial issues and a lawyer as to the registration issues.

The technique of both outside experts was to speak from hindsight. Because Lionel had large year-end adjustments in 1961, it was the accountant's opinion* that an unspecified portion of these adjustments should have been considered in the June 30 statements. He did not testify that even a single adjustment was actually required at mid-year, or the amount of any such adjustment. Because of the course of

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* As Kermit Easton, a partner of Leidesdorf and a Lionel witness at trial, testified (testimony which the trial court clearly was entitled to believe), respondents' expert did not have a sufficient basis for forming any opinion as to Lionel's June 30 financial statements from the limited papers which at trial he said he had reviewed.

the Registration Statement (which was filed September 28, 1961, and became effective one year later for a six-month period), the lawyer concluded that theoretically the best efforts covenants must have been violated. In his testimony, he did not consider any of Lionel's actual efforts in achieving registration or the obstacles that besieged it, including the many problems caused by Hathaway and its shareholders.

Lionel presented three witnesses who had experience with and knowledge of Lionel in 1961. Kermit Easton, a Leidesdorf partner, testified not only as an accounting expert but also as Lionel's outside auditor in 1961. That large adjustments are required at year-end, he said, is a neutral fact. It does not indicate that any part of these adjustments should have been made at mid-year. Mr. Easton testified that—whatever the conjecture of respondents' witness —based on his own familarity with Lionel and in his expert opinion, no adjustments were necessary in Lionel's interim financial statements which were not made. Moreover, in the course of the 1961 year-end audit of Lionel conducted by Leidesdorf, and later accounting services performed by Leidesdorf for Lionel, Leidesdorf discovered no adjustments which should have been made at mid-year 1961 and were not made.

Peter Panarites, a partner in the Washington law firm of Freedman, Levy, Kroll & Simonds, testified for Lionel with respect to the contract issues, both as an expert and based upon his own participation in Lionel's efforts with respect to the Registration Statement. He recounted in great detail the chronology of Lionel's efforts to effectuate the Registration Statement, and opined that Lionel had used best efforts and had met its registration obligations. Richard Schilling, a Lionel Vice President who was with the Company in the relevant period, testified as well.

The trial court conducted an item-by-item analysis of each of the thirteen disputed items in the June 30 financials, re-

viewed and recited the testimony as to each item, and concluded that respondents had failed to establish "by a fair preponderance of the evidence that the June 30 Financial Statements were materially false or that Lionel omitted to state any material fact necessary to make the Statements made not false or misleading." 345 F. Supp. at 662. Since the Company (and not any individual) is the only defendant in these actions, the trial court thought it particularly important in this case to hold respondents to the required burden of proof.

As to the contract issues, the trial court found that Lionel satisfied its obligation to file by October 15, 1961, by filing a Registration Statement on September 28, 1961, containing financial statements that were not materially misleading. Considering all of the facts, summarized at length in its opinion (345 F. Supp. at 663-66), the court concluded that respondents had failed to satisfy their burden of proving a failure on the part of Lionel to use its best efforts to secure and maintain effectiveness of the registration. Thus, as to all issues, the court found that respondents failed to prove their case on the merits, and dismissed the complaints.

The court below rolled up its sleeves and began the fact-finding anew as to both financial and contract issues. It conducted its own review of the testimony as to the thirteen disputed financial items, and found misrepresentations in three: good will of a newly-acquired subsidiary (Anton-Imco Electronics Corp.); raw material price variance; and research and development writeoffs.

To conclude that there was a misrepresentation as to the good will item required the court to ignore or reject Leidesdorf's testimony "as a matter of law," to find facts not in the record and facts contradicted by the documentary evidence, to misinterpret facts in the record, and to redefine the issue. With respect to the remaining two items, the court in effect adopted respondents' technique: in view of sizeable year-end adjustments, the court looked to Lionel to establish that no

additional mid-year adjustment was necessary. Whereas the trial court properly placed on respondents the duty to prove that further adjustments were necessary, the court below erroneously placed the real burden on Lionel to prove the negative.

After articulating its view that the financials were misleading, the court below found that the contract obligations may have been violated as well. In addition, it "disagree[d] with the district court" and rejected its finding that the period from filing to effectiveness of the Registration Statement was reasonable. Based on is own observations, the appellate court felt "the delay may well have been unreasonable."* 483 F.2d at 552. The case was remanded for further findings in accordance with the opinion.

ARGUMENT

I. The Court Below Has So Far Departed From the "Clearly Erroneous" Rule as to Call For an Exercise of This Court's Power of Supervision.

The court below paid homage to the mandate of Rule 52(a) of the Federal Rules of Civil Procedure that "findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." *United States* v. *Yellow Cab Co.*, 338 U.S. 338 (1949). It recognized that "we must, of course, give full weight to

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* That the delay "may well have been unreasonable" necessarily implies its correlative: the delay may well have been reasonable. Here lies the heart of error. That the appellate court may disagree with the district court is not a proper ground for reversal.

The district court conclusion was based on ample evidence. Respondents' own expert at trial acknowledged that he knows of instances where diligence and competence were used in effecting a Registration Statement, and the Statement *never* became effective. Thus, a time lapse between filing and effectiveness would not indicate a failure of best efforts.

the district court's findings of fact, even while we are free to look to the application of the securities law to the facts found." 483 F.2d at 545. In view of what the court actually did, however, these words have a hollow ring.

What the court below did is what this Court said in *United States* v. *Yellow Cab Co.*, and in many other cases, that an appellate court cannot do: try the case *de novo* on the written record, reject the findings of the trial court, and substitute new findings of its own. Clearly an appellate court—whatever its inclinations—cannot give facts another construction or "find a more sinister cast to actions which the District Court apparently deemed innocent." *United States* v. *National Association of Real Estate Boards*, 339 U.S. 485, 495 (1950).

Even its first premise, which set the stage for broad pronouncements about interim financials, in nicely turned phrases, is factually wrong. This case is not "the unhappy aftermath of a corporate marriage gone sour." 483 F.2d at 542. It is a case brought by two out of thousands of former Hathaway shareholders. There was no evidence whatever and no contention by anyone that the merger of Hathaway into Lionel had "gone sour." Similarly, the court's description of the Company showing the "frosting" but not the "dried out, if not mildewed" cake beneath, the "sweet" but not the "bitter," the "pretty package" (483 F.2d at 547), while evoking vivid images, is simply inapposite.*

* In its devotion to the metaphor of a "pretty package" which might mislead innocent stockholders, the court below ignored the factual realities of this case: plaintiffs held unregistered Hathaway stock, which might have principally motivated their willingness to accept Lionel stock; Lionel at June 30, 1961, showed a loss of $.18 per share, as against a profit of $.48 per share for the prior interim period. The six-month financial statements said on their face that they were unaudited, subject to year-end audit, and not indicative of the Company's annual operations, since Lionel's business was seasonal. The pertinent text from the Hathaway Proxy Statement is at Appendix, p. 60a.

A. *The appellate court's findings with respect to Anton-Imco are factually incorrect.* Anton-Imco was acquired by Lionel on September 30, 1960; its good will, which had been purchased and paid for by Lionel, was carried as an asset on the books of the Company. The court below found that, since there was an "uncertainty" as to the value of Anton-Imco at June 30, it was misleading as a matter of law not to footnote this uncertainty somewhere in the financial statements, so that readers might themselves assess the vaue of the good will asset carried in the balance sheet. While this may be a fine statement of principle, it is simply inapplicable to the facts of this case, since no "uncertainty" as to the value of Anton-Imco at June 30 was established.

Anton-Imco suffered a loss as of June 30, 1961, in its very first year as a Lionel subsidiary. In accordance with accounting principles requiring consolidation of wholly-owned companies (principles which are not attacked), this loss was consolidated in Lionel's statements. It is also undisputed that no portion of the good will, which had just been bought and paid for by Lionel, was written off at June 30, 1961. A six-month loss in a company which had just been purchased by Lionel, and for which Lionel had so recently paid nearly one million dollars for its good will alone, did not create "uncertainty" as to its value. Six months later, at year-end 1961, Leidesdorf in the course of its audit and certification of Lionel's financial statements concurred that no writedown was required even though Anton-Imco had suffered an additional loss. Among the prospects for success of Anton-Imco was a yet unmarketed currency recognizing device.

The court below did not disturb the trial court finding that there was no need to write down good will. This was the only issue which had been raised by respondents involving Anton-Imco. But the court went further, and in so doing, it made a number of erroneous findings of fact. Three significant instances are set forth below.

1. **The court erroneously found that "the retention of $998,000 as [Anton-Imco's] good will was based upon the prospects of success of this currency recognizing device which had not yet been marketed." 483 F.2d at 546.**

The testimony of Mr. Easton—which the appellate court disbelieved and rejected "as a matter of law"—was that at June 30, 1961, the prospects for Anton-Imco were profitability and success. An unmarketed currency recognizing device was but one example of Anton-Imco's prospects and but one illustration of the fact that at June 30, there was no uncertainty as to the Company's value. It was not, however, Anton-Imco's sole prospect for future profitability, as the court below obviously misapprehended.

The only documentary evidence in the record on this point demonstrated that Anton-Imco had many products in the fields of radiation detection and measuring devices, electronic and electro-mechanical devices and aircraft and missile components. Twenty-two examples of products other than the currency recognizing device were set forth in the Hathaway Proxy Statement. There was no evidence of any uncertainty as to these products or the business of Anton-Imco. The fact that Anton-Imco's new currency recognizing device was yet unmarketed, and there was no assurance as to its profitability, was fully disclosed in the Proxy Statement. (The pertinent text from the Hathaway Proxy Statement is at Appendix, p. 61a.) There were no documents contradicting Mr. Easton's testimony.

For the court to reject Mr. Easton's testimony "as a matter of law" and find an "uncertainty" because of a misconception about the importance of one new product in the Company's future, was improper and plain error.

2. **The court erroneously found that "since the interim statements do not include a balance sheet but only consolidated statements of income they contained no**

reference at all to the good will item. This makes them, in our view, all the more misleading." 483 F.2d at 546.

This finding of the appellate court is threaded throughout the opinion and restated at several points (483 F.2d at 546, 546 fn5, and 547-48), indicating its significance. It is plainly erroneous, since the interim statements (1) do include a balance sheet, and (2) do contain a reference to the good will item.

Consolidated Balance Sheets of Lionel and subsidiaries were included in the Hathaway Proxy Statement, and contain a separate entry of $998,076, identifying the good will of Anton-Imco as "Excess Cost of Acquisition of 40,000 Shares of Common Stock of Anton-Imco Electronics Corp. Over Underlying Book Amount at Date of Acquisition." In Footnote A thereto, moreover, Lionel disclosed that it had not adopted any policy of amortizing good will. (The pertinent text from the Hathaway Proxy Statement is at Appendix, pp. 64a, 65a.)

This document was part of the record before the trial court and was obviously overlooked by the court below.

3. **The court erroneously found that the financial statements were misleading because they emphasized the optimistic items, or " 'special items' (including such things as elimination of a $22,444 reserve for certain employee benefits) that would have improved the earnings by $.10 per share in toto for the first six months of 1961." 483 F.2d at 546.**

The court chose to ignore or disbelieve the Leidesdorf testimony as to the applicable accounting principles, and as a result completely misapprehended the purpose of separating "special items" from Lionel's income statement. Because of this misapprehension, it erroneously concluded that the statements were misleading because optimistic

items were being emphasized or, in the court's hyperbole, readers of the financials were being shown the "frosting" but not the "mildewed" cake.

Had the appellate court heard the testimony and seen all of the evidence, as the trial court did, it would have known that special items were broken out of income not because they were optimistic, but because they were items which would not normally enter into an evaluation of operations on a recurring basis. For example, the elimination of a $22,444 reserve for employee benefits in the first half of 1961 would enhance income for the period, but would not recur on a regular basis. Nor were special items always "optimistic," as revealed in the Lionel financials for an earlier period contained in the Hathaway Proxy Statement. If simply mingled with the other items of income and not broken out, these nonrecurring special items, optimistic or not, would give a distorted effect to income in comparison to income from other periods.

Thus, segregating special items actually made Lionel's interim income statements more accurate in comparison with prior years, and was not misleading. The court obviously was unaware of the relevant accounting principles and misunderstood the record.

B. *The appellate court redefined the Anton-Imco issue.* The Anton-Imco issue as presented by respondents was clearly whether or not a writedown of good will was required in view of the six-month loss and unmarketed product. The trial court concluded that no need for a writedown had been proved, and the court below did not disagree.

By accounting standards applicable in 1961, a writedown of good will was required when it became reasonably evident that the intangibles had become worthless. Accounting Research Bulletin No. 43, p. 39. No one contended that Anton-Imco was worthless at June 30, 1961. Even today,

the cost of good will may be amortized over forty years. Opinions of the Accounting Principles Board, No. 17, "Intangible Assets," p. 340. "[A] single loss year or even a few loss years together do not necessarily justify an extraordinary charge to income for all or a large part of the unamortized cost of intangible assets." Opinion at 341.

But under a different theory than any tendered by plaintiffs, the court erroneously found a misrepresentation. The issue created and decided by the appellate court was whether or not, in the condition Anton-Imco was known to be in at June 30, 1961, it was a misrepresentation not to footnote the existence of a loss for one six-month period. The court determined that it is a misrepresentation not to disclose uncertainty in the first financial statement issued after the uncertainty becomes known. This of course assumes that there was uncertainty as to the value or future profitability of Anton-Imco at June 30, 1961—a fact which was never proved. On the issue decided, which was not considered by counsel for either party or the trial court, the court below simply did not have a sufficient factual basis for its finding of a misrepresentation as a matter of law.

C. *The court was inconsistent in its findings of fact.* The trial court found that no misrepresentation was shown as to research and development writeoffs or as to obsolescence. Both items were treated alike by Lionel and present identical considerations. The court below, however, rejected the finding as to research and development only, and found that absent further proof by Lionel there was a misrepresentation. This inconsistency is not supported by the evidence, and is plain error.

Like obsolescence, the evidence demonstrated that research and development costs to be written off could not be anticipated as of June 30. Like obsolescence, it was not until year-end—after Lionel's Christmas season—that Lionel could determine the success of a new line of toys,

and consequently it was not until year-end that a determination could be made as to the research and development expenses to be written off. Like obsolescence, and for the very same reasons, the findings of fact of the trial court with respect to research and development writeoffs should not have been disregarded.

Similarly, the court below improperly separated the item of raw material price variance from inventory in finding that absent further proof by Lionel there was a misrepresentation. Raw materials are a part of inventory, and in its interim financials this item was treated by Lionel on the same basis as the other inventory items. Lionel valued its inventory (including raw materials) on a *computed* figure at mid-year, rather than actual costs. With respect to raw material price variance, in particular, since no physical inventory was taken by Lionel at June 30 (a fact disclosed in the financial statements), there could be no basis upon which to make an allocation of a price variance between raw materials still on hand and those already sold as part of finished goods, if one existed. The method used by Lionel was fully disclosed in the notes to the financial statements, and was in accordance with generally accepted accounting principles. (The pertinent text from the Hathaway Proxy Statement is at Appendix, p. 66a.)

The court did not disturb the trial court's findings with respect to this method of interim reporting for any inventory item other than raw material price variance. The inconsistency is not supported by the evidence, and is plain error.

Significantly in *Bowman & Bourdon, Inc.* v. *Rohr,* 296 F. Supp. 847 (D. Mass.), *aff'd per curiam,* 417 F.2d 780 (1st Cir. 1969), relied upon by the court below, the Massachusetts court held that "where the total inventory figure is misleading *unless details as to how it was computed are revealed,* the law imposes on Rohr the positive duty to disclose sufficient additional information necessary to make

the figures supplied not misleading." 296 F.Supp. at 851 (emphasis added). In the case at Bar, the full details as to how inventory was computed were revealed, and the failure to make an additional adjustment for raw material price variance was not misleading.

II. Shifting the Real Burden of Proof on the Primal Question of Misrepresentation Disregards a Basic Principle of our Judicial System.

The trial court held that since only Lionel is a defendant, so that any recovery from Lionel will be paid out of its assets at the expense of its other stockholders, it is all the more essential that the respondents prove their case by a fair preponderance of the evidence. 345 F. Supp. at 658. The court found that respondents failed to prove their contention as to the item of raw material price variance, since "there was no evidence presented [by plaintiffs] from which the need of such an adjustment could be determined, or any evidence as to Lionel's raw material purchases during the six-month period." 345 F. Supp. at 660. As to research and development writeoffs, again the trial court found against plaintiffs since there was no evidence "to indicate an adjustment should have been made" (345 F. Supp. at 661).

The appellate court disagreed, and found misrepresentations as to both items because of a failure *on the part of Lionel* to prove that no adjustment was necessary. While the court below talked of burden of "going forward" rather than burden of proof, as a practical matter the court permitted plaintiffs to avoid their burden of proof by creating a presumption of wrongdoing at mid-year because of large year-end adjustments. The court even divined from the size of the year-end adjustments that "a worsening financial situation appears to have been developing through the first half of 1961 while accelerating in the second half." 483

F.2d at 552. There was no evidence whatever of such a trend.

As to the item of raw material price variance, the court below shifted the burden to Lionel based on the size of the year-end adjustments and "the likelihood that a substantial portion of raw material purchase price variance was known to Lionel before June 30." 483 F.2d at 548-49. Applying fundamental principles, as applicable in securities cases as other private civil litigation, it should have been *respondents'* duty to prove that there was an actual raw material price variance at June 30 which was omitted from the interim financials. Similarly, on the research and development item, the court below observed that the size of the writeoff at year-end was "substantial," and looked to Lionel for explanation of why no mid-year adjustment was necessary. 483 F.2d at 549. Again, it should have been *respondents'* burden—as the trial court found—to prove that adjustments were actually required which were not made. Apart from years of pre-trial discovery, at the trial respondents had subpoena power and cross-examination. For the court to find misrepresentations by Lionel, despite respondents' failure of proof, is at odds with a basic tenet of our judicial system. *United States* v. *Yellow Cab Co.*, 338 U.S. 338 (1949).

The uncontroverted testimony was that in the view of Lionel management, no further mid-year adjustment for research and development costs was actually required. In the course of the year-end audit, nothing came to Leidesdorf's attention which demonstrated a need for further mid-year adjustments in that item or any other. This testimony should have satisfied any burden of "going forward." But the court below completely rejected it since the "findings tell us nothing about the basis for Lionel's and Leidesdorf's conclusions." 483 F.2d at 549.

It was for *respondents* and not the Court of Appeals to discredit this testimony and prove it unworthy of belief,

by cross-examination and by evidence, but they did not do so. It is plain error and a fundamental unfairness to shift the burden of proof to the Company in these circumstances.

Plaintiffs have already moved in the trial court for entry of judgment based on the opinion of the court below, claiming that in view of the diluted requirements of proof as to materiality, reliance, causation and *scienter,* a finding of misrepresentation is now virtually tantamount to a finding of liability under the securities laws. Respondents point out that the concept of materiality is almost implicit when misrepresentations are found in a financial statement used for purposes of a merger. On the issue of materiality, the court below said that the principles to be applied to the contract claims were even "less strict." 483 F.2d at 552. Under *Crane Co.* v. *Westinghouse Air Brake Co.,* 419 F.2d 787 (2d Cir. 1969), *cert. denied,* 400 U.S. 822 (1970), respondents claim, proof of reliance and causation are no longer necessary, but are to be presumed. As to *scienter,* respondents say that this too may be inferred from the very existence of substantial misrepresentations in financial statements prepared by sophisticated corporate managers. Clearly the new standards no longer require proof of specific intent. *Lanza* v. *Drexel & Co.* 479 F.2d 1277 (2d Cir. 1973) (en banc).

While Lionel disputes respondents' present position below, it demonstrates the very real danger of the lower court decision. If, owing to diluted requirements of proof as to materiality, reliance, causation and *scienter,* a finding of liability may be virtually inferred from proof of a misrepresentation, then shifting the burden to a company to prove that its financials are free from misrepresentation goes beyond even concepts of absolute liability, where a plaintiff at least must prove that defendant committed an act, and that the act caused him injury.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Second Circuit.

Respectfully submitted,

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December 5, 1973

APPENDIX

Opinion of the Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 529, 530—September Term, 1972.

(Argued March 13, 1973 Decided July 17, 1973.)

Docket Nos. 72-1901, 72-1902

REPUBLIC TECHNOLOGY FUND, INC.,

Plaintiff-Appellant,

v.

THE LIONEL CORPORATION,

Defendant-Appellee.

THE NEW ENGLAND INDUSTRIES, INC.,

Plaintiff-Appellant,

v.

THE LIONEL CORPORATION,

Defendant-Appellee.

Before:

HAYS, MULLIGAN and OAKES,

Circuit Judges.

Appeal from a judgment in the Southern District of New York, Dudley B. Bonsal, *Judge*, 345 F. Supp. 656 (S.D.N.Y. 1972), dismissing appellants' claims of securities law and contract violations based on alleged materially misleading

interim financial statements included in proxy materials distributed prior to a merger.

Affirmed in part, reversed and remanded in part.

SHELDON H. ELSEN, New York, N. Y. (Lewis Shapiro and Leslie A. Lupert, New York, N. Y., on the brief), *for Plaintiffs-Appellants.*

JAMES E. TOLAN, New York, N. Y. (Judith S. Kaye, New York, N. Y., on the brief), *for Defendant-Appellee.*

OAKES, *Circuit Judge:*

This case is the unhappy aftermath of a corporate marriage gone sour, with the bride's family claiming that the groom failed to disclose a number of liabilities at the time of the negotiations leading up to the nuptials. The appeal is from a judgment absolving the appellee from liability under either contractual or securities law in connection with an interim (six months') financial statement, used in proxy materials and in a registration statement, prepared relative to the merger of Hathaway Instruments, Inc. ("Hathaway"), into The Lionel Corporation ("Lionel"). Appellants were stockholders in Hathaway. Their principal claim below and here is that the interim statement (and hence the proxy materials and registration statement) was misleading in that it artificially inflated earnings because it did not reflect $2,221,000 of adjustments that at year's end were ultimately required and also because it contained no write-off of good will of a subsidiary that was losing money at the time. The case essentially involves, therefore, the scope of a corporation's duty to make its interim financial statements accurately reflect the real

state of fiscal affairs prior to a merger, or, put another way, the extent to which in an interim statement adjustments that are or should be made at year's end must be anticipated.

I. Factual Background and Proceedings Below.

Appellants are both investment funds. Appellant Republic Technology in July, 1960, purchased 25,000 shares of common stock in Hathaway. This stock was not registered but Hathaway had agreed to use its best efforts to cause it to be registered on request from Republic Technology. Appellants between them later purchased another 40,000 shares of Hathaway stock in March, 1961.[1] In return, Hathaway agreed that it would prepare and file with the SEC a Registration Statement for the stock on or before May 15, 1961, and that it would use its best efforts to the end that such registration would become and remain effective for a period of not less than 24 months from the effective date thereof. No request to register was required under the March, 1961, purchase.

Lionel was the well-known toy and train manufacturer that, after some years of successful operations, entered into a program of corporate acquisitions, one of which was Anton-Imco Electronics Corp., which in turn owned Intercontinental Manufacturing Co., Inc., and Anton Electronics Laboratories Inc. (Anton-Imco and its two subsidiaries are sometimes collectively referred to herein as the "Anton-Imco" or "electronics division" of Lionel.) Further to complicate matters a little, the Anton Electronics Laboratories Inc. corporate name was changed in March of 1961 to Lionel Electronic Laboratories Inc. (hereinafter "Lionel Labs"), but it remained with Intercontinental a

1 There were 1,022,727 shares of Hathaway stock as of the effective date of the Hathaway-Lionel merger on November 6, 1961.

subsidiary of Anton-Imco. Lionel Labs made "radiation detection and measuring devices" and "electronic and electro-mechanical devices." Intercontinental manufactured aircraft and missile components. These last two together provided, apparently, some "glamor" to the corporate package. Other Lionel acquisitions included Airex, a fishing tackle concern, and Telerad, a "microwave components" concern. Up to the ultimate Hathaway merger in November, 1961, the stock of Lionel had been selling at two to four times its book value despite the fact that even on the June 30, 1961, interim statement here in dispute Lionel was losing money during the first six months of 1961.

Prior to the Lionel merger, appellant Republic Technology exercised its option to request registration of its Hathaway shares and on or about May 7, 1961, Hathaway filed a registration statement. When merger discussions with Lionel commenced in June of 1961, however, Hathaway requested permission from the SEC to withdraw this registration statement. This permission was not granted until late September when Lionel filed its registration statement with the SEC.

Meanwhile, however, unaudited financial statements for the six months' period ending June 20, 1961, had been prepared for Lionel and Hathaway and a combined pro forma for that period had also been prepared. These figures showed a six months' loss for Lionel of $84,000 or $.06 per share and a combined pro forma profit of $245,000 or $.08 per share. It is the omission of the Lionel statement to show certain adjustments made at year's end or to take into account by way of adjustment to Anton-Imco good will that subsidiary's losses that is the crux of the controversey here.

The interim statements were used in connection with the agreement of merger dated September 15, 1961. Under its terms Lionel agreed to file on or before October 15, 1961, a registration statement covering all stock acquired by

Hathaway stockholders which by previous agreement Hathaway was legally obligated to register. Lionel also agreed to undertake Hathaway's obligations to effectuate and maintain the effectiveness of a registration statement. The same six months' figures were used in the proxy materials submitted to Hathaway and Lionel stockholders to obtain their approval of the merger, which approval ensued on October 25, 1961, effective on November 6, 1961. They also were used in the registration statement, Form S-1, filed with the SEC on September 28, 1961, by Lionel. Pursuant to the merger appellants exchanged their 65,000 shares of Hathaway common for 21,667 shares of 3¾% convertible preferred stock of Lionel.

There were a number of adjustments recorded as of December 31, 1961, as a result of the year-end audit or of events occurring during the fourth quarter of 1961. Of these, the ones appellants most insistently claim should have been reflected in the June 30 interim statement are:

1. Inventory write-downs: In Lionel's toy and train division $262,830 for inventory obsolescence was written down in the fourth quarter or written off as at December 31: $140,000 was a write-off as "raw material price variance," $77,946 was a write-down to lower of cost or market; and the rather remarkable sum of $256,000 was written off as "unlocated difference between December 31, 1961 book and physical inventory." In Lionel's Telerad division $100,000 of inventory was written off in the fourth quarter and $440,000 was required to be written off at year's end. In Lionel Labs $200,000 was written down in inventory at year's end. The total of these year-end write-offs was $1,476,776.

2. Sales returns and allowances: A total of $106,000 was provided at year's end for sales returns and allowances in the toy and train division and the Airex division.

3. Research and development: Research and development costs totaling $226,983 in the toy and train division and $163,000 in Lionel Labs were written off at year's end.

4. Deferred selling, advertising and service expense: Lionel wrote off $249,000 of these expenses in its toy and train division at year's end.

The total of the above adjustments which were made at year's end is $2,221,659.

Appellants also claim that the interim statement:

5. Should have reflected a write-off in good will attributable to Lionel's Anton-Imco division, which was carried at $998,000, despite a $189,000 loss for the first six months of 1961;

6. Should have reflected a greater reserve for bad debts, sales returns and allowances;

7. Should not have included two credit items (one for sales returns and allowances of $24,000 and one for cooperative advertising expense at $19,234) and one government contracts item of $51,369.

Appellants point out that each $30,000 of adjustments would have reduced profits shown in the proxy materials and registration statement by one cent per share (of the merged company). Indeed, after the year-end adjustments were actually made, without even counting any write-down of Anton-Imco good will, the consolidated profit expected to be shown in the interim statement became a loss in the sum of $1,898,609, and when added to this were $633,668 of special charges, the overall loss totaled over $2.5 million or $1.71 per share.[2]

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2 The "special charges" apparently did not relate to the items objected to by appellants but to moving, consolidation, contractual and uniform accounting expenses; one might call them the hidden expenses of merger.

The district court, sitting without a jury, took testimony both from appellants' accounting expert, Mr. Duchan, and from Mr. Easton, the senior managing accountant for S. D. Leidesdorf & Co. ("Leidesdorf"), independent certified public accountants, who worked on the Lionel audits in 1960 and 1961. Mr. Easton testified both to his preparation of the financial statements in question and as an accounting expert. It may not come as a surprise that while Mr. Duchan testified that in his opinion the June 30 statement should have reflected a substantial portion of the adjustments that were actually made at year's end, Mr. Easton's testimony was to the effect that the interim statement was accurate (in addition to being in accordance with the same generally accepted accounting principles used in Lionel's year-end statements and its prior financial statements).

The district court in an opinion printed at 345 F. Supp. 656 (S.D.N.Y. 1972) held that plaintiffs (appellants) had "not established by a fair preponderance of the evidence that the June 30 Financial Statements were materially false or that Lionel omitted to state any material fact necessary to make the statements not false or misleading." 345 F. Supp. at 662. It sought to distinguish *Kaiser-Frazer Corp.* v. *Otis & Co.*, 196 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952), on the ground that the Kaiser-Frazer management used figures in its interim statement that they knew to be untrue while there was no evidence that the Lionel management acted similarly. 345 F. Supp. at 663. It found no violations of § 17 of the Securities Act of 1933, 15 U.S.C. § 77q, or of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. While holding that the Hathaway proxy statement was not subject to § 14 of the 1934 Act, 15 U.S.C. § 78n(a), and Rule 14a-9,

17 C.F.R. § 240.14a-9 (since the Hathaway common was not registered), the court also held that plaintiffs had failed to establish that the proxy statement was materially misleading or that it had omitted material facts necessary to make it not false or misleading. 345 F. Supp. at 663 n.6. With respect to the contractual claims, the court found that the interim financial statements were not materially misleading, and that the Lionel registration statement and prospectus did become effective within a reasonable time. Further, the court held that Lionel had discharged its obligation as Hathaway's successor to use best efforts to keep the registration statement and prospectus effective, because it was the unwillingness of the auditor to certify the necessary financial statements due to Lionel's accumulating losses that largely led to delay in registration and the ineffectiveness of the registration. The complaint was accordingly dismissed. We will discuss the securities law claims separately from the contractual law claims, and in that order.

II. Securities Law Claims.

A. *Section 14 and Rule 14a-9.* We commence by agreeing with the district judge in respect to his treatment of the claim under Securities Exchange Act § 14 and Rule 14a-9. The claimed violation of the proxy rules must fail because proxies were not solicited "in respect of any security . . . registered pursuant to section 12" of the Act. Securities Exchange Act of 1934, § 14a, 15 U.S.C. § 78n(a); SEC Rule 14a-2, 17 C.F.R. § 240.14a-2. *See* 5 L. Loss, Securities Regulation 2835-36 (1969). Thus, whatever the scienter requirement in respect to a private action for damages to redress a § 14 and Rule 14a-9 violation, *see Gerstle* v. *Gamble-Skogmo, Inc.*, No. 72-2259 (2d Cir., May 9, 1973), slip

op. at 3437-41, there is simply no liability in respect to proxy-rule violations here.

B. *Rule 10b-5, § 17 and Lionel's Interim Accounting.* Under both Rule 10b-5 and § 17 of the Securities Act of 1933, 15 U.S.C. § 77q(a), however, it is necessary to determine whether Lionel made "any untrue statement of a material fact" or an omission "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ." Were the interim financial statement and the proxy statement and initial registration statement which utilized the interim statement "misleading" in view of "the circumstances" underlying the transaction?[3] In answering this question we must, of course, give full weight to the district court's findings of fact, even while we are free to look to the application of the securities law to the facts found. *See Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, No. 72-1053 (2d Cir., Mar. 16, 1973), slip op. at 4933 (opinion of Timbers, *J.*). Taking the evidence in the light most favorable to the defendant, Lionel, we nevertheless find certain omissions in the interim statement to have been misleading.

1. *Anton-Imco Good Will.* We commence with the $998,000 item for good will of Anton-Imco Electronics Corp., as to which the interim statement of earnings reflected no discount even though this subsidiary had sustained a loss of $188,842 as of June 30.[4] Mr. Easton, Lionel's auditor,

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3 Securities issued or surrendered in a merger are purchased or sold for 10b-5 purposes. *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262, 266-67 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967). *See* 1 A. Bromberg, Securities Law Fraud, SEC Rule 10b-5 § 6.5(2) at 138-38.1 & 138.1 n.95 (1971).

4 For the full 12-month period the loss was some $724,000 and there was apparently considered at year's end a partial write-down of $307,984 in the good will item, but this was not taken.

acknowledged that the operating loss of Anton-Imco was a "factor to be considered" in deciding whether there was a diminution of the good will. He felt, however, that this single factor was outweighed by the fact that Anton-Imco was only in its first year of operation as a Lionel subsidiary and in his words was "engaged in the development of a new machine—I believe it was a money sensor, a money changing device—and based on all the information that was available at that time the prospects for success seemed very reasonable." Thus, in the opinion of Mr. Easton, credited by the district court, despite Anton-Imco's losses there was no "diminution in value" of its good will.

We cannot accept Mr. Easton's evaluation as a matter of law. The notes to the consolidated interim statements of income contain the following statement:

> This company recently designed and developed a currency recognizing device, several prototype models of which have been built up to this time. The device has not yet been marketed and there is no assurance at this time as to whether it will be a profitable item.

Nowhere do the notes in any way indicate that Anton-Imco had shown a $189,000 loss as of June 30 or that the retention of $998,000 as its good will was based upon the prospects of success of this currency recognizing device which had not yet been marketed. *Cf. Petersen Engine Co., Inc.*, 2 S.E.C. 893, 906 (1937); *Lewis American Airways, Inc.*, 1 S.E.C. 330, 342 (1936) (misleading to designate "patent applications" as "patent rights" or "patents" under intangible assets heading in a balance sheet). Indeed, since the interim statements do not include a balance sheet but only consolidated statements of income they contained no reference at all to the good will item. This makes them, in our view, all the more misleading. The person viewing

the statements would have no reason to suspect that the consolidated earnings were at least subject to question since despite a loss on the part of a major division for the first half-year, its good will was still being carried at a full initial valuation equivalent to about 8 per cent of the Lionel total book value.[5] *Cf.* R. Mautz, Financial Reporting by Diversified Companies 157-58 (1968) quoted in T. Fiflis & H. Kripke, Accounting for Business Lawyers 556-57 (1971) (investor needs to know "relative importance" of several industries comprising a diversified corporation accurately to forecast future prospects). This is particularly so when the notes emphasize optimistic items, *e.g.*, calling attention to the fact that the interim statement did not include certain "special items" (including such things as elimination of a $22,444 reserve for certain employee benefits) that would have improved the earnings by $.10 per share in toto for the first six months of 1961. In other words, the voters on the merger were being shown the frosting on the cake with no allusion in the statements to the fact that a substantial part of the cake itself was dried out, if not mildewed. *Cf. Globe Aircraft Corp.*, 26 S.E.C. 43, 46-47 (1947).

At the very least, good disclosure accounting would have required the notation of some uncertainty regarding the overall interim Lionel profit picture, based on this item alone, uncertainty which should have been footnoted, to avoid misleading the stockholder. *See* SEC Accounting Series Release No. 62, 4 CCH Fed. Sec. L. Rep. ¶ 72,081 at 62,149 (1947) (footnoted explanation must be included in a summary earning statement if the information it

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5 The exhibits supplied do not contain any balance sheet. But the proxy statement in support of the merger sets forth a $9.89 per share book value for Lionel stock as of June 30, 1961, and that there were 1,138,455 shares of Lionel stock outstanding at that date. This would result in a total Lionel book value of $11,259,519.95.

would contain is of such "special significance [that] . . . its omission would be likely to give rise to misleading inferences"). *Cf. Metropolitan Personal Loan Corp.*, 7 S.E.C. 234, 239 (1940) (even assuming deferred asset account could be written off in a single year, footnoted explanation required to make income statement not misleading). While stockholders who are voting on a merger are not to be treated like "children in kindergarten," *cf. Gerstle* v. *Gamble-Skogmo, Inc., supra,* slip op. at 3434, they are entitled to disclosure of the bitter with the sweet. They are at least entitled to assume that the interim financial statements furnished them by their own company or the other party to the merger will give them better than "ballpark" figures and be based on principles of conservatism which the American Institute of Certified Public Accountants speaks of as "a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income." I APB Accounting Principles § 1022.27 at 140 (CCH ed. 1971). The stockholders are entitled to assume that uncertainty concerning profit or loss should be at least footnoted in the first financial statement issued after the uncertainty arises.

This is, perhaps, another way of saying that in a day and age of mergers and conglomerates—Lionel in the 1960 era was what might be called a baby conglomerate, branching out from toy trains to outboard motors, fishing tackle, electronic and nuclear instruments, and educational science toys, among other things, in addition to "currency sensors" —it is as important to shareholders, perhaps more so, that interim statements issued for merger approval purposes accurately reflect corporate events as that the year-end financial statement dressed in the pretty package of an annual report be in accordance with sound or generally accepted accounting principles. Fairly to be able to vote on a merger requires accurate information. Perhaps noth-

ing is more relevant to a vote on whether or not to approve a merger than the earnings picture of the acquiring company, at least to the stockholder of the company being acquired. As was said by Judge Augustus Hand in the somewhat different but nevertheless analogous situation of a registration statement regarding stock in a new automobile company, "it is evident that the prospective purchaser of . . . stock would rely heavily on the corporation's sales and earnings during the last quarters . . . without a favorable picture of earnings for that period the proposed stock issue could not have been made." *Kaiser-Frazer Corp.* v. *Otis & Co., supra*, 195 F.2d at 840. Here, as there, sales and earnings were set forth in summarized form in a table and "[i]t is apparent, then, that the table summarizing earnings was an important factor in the sale of the stock (or merger, as the case might be) . . . ." *Id.* Here, as there, "failure to make full disclosure therein of all the facts bearing upon the Corporation's earnings" was misleading. *Id.* We do not agree with the district court that *Kaiser-Frazer* is distinguishable from this case. Here, as there, the accounting presentation in the summary income statement did not disclose facts of real significance to the voting stockholder. Issues of scienter are and should be separable from the question whether the financial statements were in fact misleading. (*See* Part IIC of this opinion *infra*.) We hold that the omission by Lionel to make any reference in the interim statement to the substantial good will item and the significant interim loss, when coupled with mention of the unmarketed "currency recognizing device" was misleading as a matter of law.

2. *Inventory Write-downs.* The same does not hold true, however, for the extraordinarily high inventory adjustments made at year's end in reference to the toy and train division and the Lionel Labs. Only a year's end physical inventory was taken; the interim statements point

this fact out and indicate that merchandise inventories in the interim statements were "estimated by the management by adding purchases, direct labor and factory overhead . . . and deducting therefrom estimated cost of goods sold," the interim overhead being allocated to the cost of goods sold on the basis of 1960 and 1961 estimated annual production and sales. This disclosure makes virtually unassailable the district court finding that at least as regards the $77,946 "shrinkage" and the $256,000 "unlocated difference" items in the toy and train division there was nothing misleading. To discover a shrinkage or lost (or stolen) merchandise requires a physical inventory, and there is no contention here, nor was there any below, that a physical inventory should have been taken as of June 30.

The statement in the notes also supports the findings in reference to the $540,000 written off at year's end in the Telerad Division; according to Easton's testimony he made inquiry in connection with the June 30 statement and ascertained that the general manager of the Telerad Division expected the rather large inventory accumulation to be recoverable in future sales. The notes to the interim statement indicate that the inventory figures were based on management estimates and there was no evidence from which the court below could have found that the Telerad estimate was unreasonable at the time it was made.[6]

There was also a $262,830 year-end adjustment in the toy and train division for "inventory obsolescence" and an unexplained $200,000 write-down in the Lionel Labs inventory. Besides a passing reference to the existence of the $200,000 Lionel Lab inventory write-down in a footnote, however, the court's opinion or findings do not mention it further. But the trial court found that because the toy and train business was seasonal, the season being a

6 Which is not to imply that negligence alone is enough to support a 10b-5 violation. *See* Part IIC of this opinion *infra*.

Christmas one, with less than 10 per cent of the company's business emanating from the spring toy sale, the obsolescence could not have been anticipated as of June 30; again we cannot disregard this finding, one of fact.[7] From this, coupled with the court's other findings in respect to inventory write-downs and the absence of any evidence indicating that something occurred prior to June 30 to warrant a write-down for obsolescence or the like, we believe that the court below treated this write-down as similar to others. If we are wrong, however, the district court will have an opportunity to correct us on the remand of the case.

The inventory adjustment most difficult to deal with is the year-end $140,000 "raw material price variance," because it would seem fairly certain that manufacturing and raw material purchases must have occurred well before June 30, even in the Christmas seasonable toy and train division. The court's "finding" that "there was no evidence presented from which the need of such an adjustment could be determined, or any evidence as to Lionel's raw material purchases during the six-month period," 345 F. Supp. at 660, must be examined in the light of the expert testimony that generally accepted accounting principles require interim inventory adjustment and the likelihood that a substantial portion of the raw material purchase price variance was known to Lionel before June 30. These facts seem to us to place on Lionel the burden of going forward with evidence to show that no adjustment needed to be made; here there was every reason to suppose that a substantial portion of the variance occurred prior to the date of the issuance of the statements for merger

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7 Technically, this was not a finding, but rather a repetition in the court's findings of Easton's testimony. This was true in a number of instances, and we would caution that a mere repetition of testimony is not a finding. *See generally* 2B W. Barron & A. Holtzoff, Federal Practice and Procedure § 1127 (1961).

purposes. *Cf. Bowan & Bourdon, Inc.* v. *Rohr*, 296 F. Supp. 847 (D. Mass.), *aff'd per curiam*, 417 F.2d 780 (1st Cir. 1960); T. Fiflis & H. Kripke, *supra* at 237-38.

3. *Sales Returns and Allowances.* One might think indefensible the omission in the interim statements to make any adjustment for sales returns and allowances, items which amounted to $54,000 in the toy and train division and $52,000 in the Airex (sometimes referred to as the fishing tackle) division. An S-1 Registration Statement requires inclusion of "Gross sales less discounts, returns and allowances." 17 C.F.R. § 210.5-03-1A. Since the train business is, as we say, "Christmas seasonable," one would think that returns and allowances would occur early in the following year, and hence would have to be shown in the following interim statement. But the trial court accepted Mr. Easton's testimony that October, November and December sales would be reduced by January and February returns and allowances as meaning that only the year-end statement would show any substantial amount for returns and allowances. We are bound by that finding, which does not appear to be clearly erroneous.

As to Airex, the so-called fishing tackle division, there was evidence that the fishing tackle business is seasonal in the spring. There was also evidence, however, again from Mr. Easton and again believed by the trial court, that the Airex returns and allowances related to Japanese manufactured baseball gloves, golf equipment and some other equipment that Airex sold in the second half of the year, and that Airex had gone out of the fishing tackle business altogether in March of 1961. Here again Easton testified that no June 30 adjustment was required because the great bulk of returns and allowances occurred right *after* Christmas sales. The trial court accepted the testimony and its finding was not "clearly erroneous."

4. *Research and Development.* Research and development (R & D) costs totaling $226,983 in the toy and train division and $163,000 in Lionel Labs were written off at year's end. It is no answer, we feel, to say as both Mr. Easton testified and the court "found" (again, basically repeating Easton's testimony) that "Lionel reviewed its research and development projects as at June 30" and when Easton's firm, Liedesdorf, made the year-end audit it found nothing to indicate that an adjustment for R & D expense write-off should have been made at June 30. Such findings tell us nothing about the basis for Lionel's and Liedesdorf's conclusions. It is a partial answer to say, as appellee's brief points out, that in fact $40,205.99 of R & D expense was written off at June 30, but an examination of the exhibit to which this refers shows that this was in the *electronics* division, for "abandoned projects." There remains unexplained why no adjustment was made at June 30 in the *toy and train* division, and here too we think the burden of going forward was upon Lionel. Here too we are talking about a substantial write-off item which at year's end represented about 2 per cent of the book value of the company, as well as several cents a share profit (or loss).

5. *Deferred Selling, Advertising and Service Expense.* Some $249,000 of selling, advertising and service expenses were treated as "Deferred Charges" at June 30 and written off at the end of the year.[8] The court evidently relied upon

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8 There is some confusion here, both in Easton's testimony and the court's findings in the light of a Leidesdorf schedule prepared in April, 1962, indicating that perhaps this item should have been written off as of September 30, 1962. The confusion is not aided by the somewhat arcane accountant's jargon describing this: "[d]eferred selling, advertising and service expenses deferred as at September 30, 1961, which should have been expensed at September 30, 1961, if the budgeted sales

Easton's testimony in respect to the bad debt reserve differential between June 30 (a reserve for "Doubtful Accounts" of $72,000 against accounts receivable of $3,312,000 or 2.1 per cent) and year's end (a reserve of $315,000 for "Doubtful Accounts, Discounts, Returns and Allowances" against $3,649,000 of accounts receivable or 8.5 per cent). That testimony essentially pointed out that the reserve at year's end included a reserve for discounts, returns and allowances, items not included as of June 30. Appellants' response is that to the extent that the understatement in June involved sales returns and allowances it duplicates appellants' argument that a June 30 adjustment was needed for those items. Again, however, it must be remembered that Lionel's business was Christmas seasonal. Overreporting of deferred expenses early in the year might well not have provided an accurate picture of the company's condition. Appellants failed to present evidence that the year-end reserves were overstated in relation to the full year's sales. For all we know the entire difference of almost 6 per cent between the ratio of reserve to accounts receivable in the interim and the year-end statements may be explained by the addition of a reserve at the end of the apparently bad selling year of 1961 for sales returns and allowances.

6. *Miscellaneous Items.* The three miscellaneous items regarding a contract price adjustment on a government contract, a credit balance in sales returns and a credit balance in a cooperative advertising expense account together amount to about $94,000 and were treated by the court below as having been too small to "have materially

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and expense used in the September 30, 1961, computation of the deferral were actual sales and expense for the year 1961." Since there is no indication that sales fell off projections before June 30, however, we need not probe the mysteries of this item.

changed the overall [interim] picture. . . . "[9] 345 F. Supp. at 662. We are constrained to agree.

7. *Summary.* In summary, then, we believe that there was a misrepresentation in respect to the $998,000 good will item, the $140,000 raw material price variance and the $226,983 R & D costs in the toy and train division, and that on the basis of the evidence adduced the interim statement should have disclosed uncertainty regarding the first and made some adjustment in respect to the other two. Absent further proof we may assume that the adjustment should have equaled 50 per cent of the last two adjustments that were actually made at year end, or $70,000 and $113,491 respectively, sums which we find substantial enough to warrant consideration on remand.

C. *Materiality, Scienter and Reliance.* The district court did not consider separately the issues of materiality on the one hand and deceptiveness of the representations in the interim statements on the other hand. Rather, as we have indicated, its findings were basically to the effect that each of the alleged omissions did not involve a "misrepresentation." Since we have found, however, that in certain respects there were misrepresentations, we must remand unless we can say that under no construction of the evidence could the district court find that the misrepresentations were material or that there was established the necessary culpability on the part of Lionel.[10] We by no means can say so.

We have touched upon the issue of materiality in reference to the Anton-Imco good will issue. Where a merger is in prospect, the earnings picture of the acquiring cor-

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9 The court also said there was "no showing that any of them involved a material misrepresentation." 345 F. Supp. at 662.

10 All of this relates solely to the alleged securities law violations. The contract claim will be dealt with separately.

poration has to be of real significance to the stockholders of the corporation proposed to be acquired, and the most current earnings are of the highest importance. *See Kaiser-Frazer Corp.* v. *Otis, supra.* Accordingly, failure to convey these earnings accurately, if the discrepancy is at all substantial, has to be material to the person being misled. The test in this 10b-5 and § 17 case is the same as set forth (albeit in a 14(e) case) by Judge Timbers:

> The concept of materiality focuses on the weightiness of the misstated or omitted fact in a reasonable investor's decision to buy or sell. We articulated the materiality standard in *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2 Cir.), *cert. denied*, 382 U.S. 811 (1965), to be "whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.'" The materiality test is concerned only with whether a prototype reasonable investor would have relied. See *Heit* v. *Weitzen*, 402 F.2d 909, 912-14 (2 Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). Account must be taken of all the surrounding circumstances to determine whether the fact under consideration is of such significance that a reasonable investor would weigh it in his decision whether or not to invest. See *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2 Cir. 1968) (*en banc*), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969).

Chris-Craft Industries, Inc. v. *Piper Aircraft Corp., supra*, slip op. at 4931 (footnote omitted).[11]

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11 As refined in the opinion of Chief Judge Friendly in *Gerstle* v. *Gamble-Skogmo, Inc.*, No. 72-2259 (2d Cir., May 9, 1973), the standard of materiality in a case under § 14(a) where *negligence* alone suffices to establish culpability, slip op. at 3436-41, is somewhat higher: ". . .

The district court never reached the question of culpability. On remand it should do so, bearing in mind that to a large extent the accountants preparing the interim figures were relying upon management for information and advice. The test to be applied is clear in terms, if not in application. As explicated most recently in the opinions of Judge Timbers and Judge Mansfield in *Chris-Craft Industries, Inc., supra,* slip op. at 4931 (Timbers, *J.*) and slip op. at 4999 (Mansfield, *J.*), something short of specific intent to defraud is required and something more than "mere" negligence; certainly, knowledge of the fact that the figures created a false picture is enough, and on the part of sophisticated corporate managers a reckless disregard of the truth is sufficient. *See Lanza* v. *Drexel & Co.*, No. 35794 (2d Cir., Apr. 26, 1973), slip op. at 3090 & n.98 (en banc); *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (dictum); *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1290-91 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Heit* v. *Weitzen*, 402 F.2d 909, 913-14 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969). *See also SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 n.15 (2d Cir. 1972). We are satisfied that on the remand that we require, the district court will treat the issues of materiality and culpability with specificity and in the light of the more recent pronouncements of this court and its various panels.

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a standard tending toward probability rather than mere possibility is," Judge Friendly said, "more appropriate." *Id.* at 3444. Here of course this would be a § 14 action were it not for the fact that the securities were not registered. But to attempt to refine the standard of materiality even further to suit this case would, we think, be distinguishing, and dividing "A hair 'twixt south, and south-west side." S. Butler, Hudibras Pt. I, Canto I, l. 65.

III. The Contract Claims.

Appellants below claimed three separate breaches of contract by Lionel that were dealt with by the district court.[12] The first breach claimed was of the Agreement of Merger since the registration statement filed thereunder was materially misleading and hence defective. The trial court held that it was not "materially misleading" and hence against appellants on this claim. Since we have found it to have been misleading and leave open the question of materiality—to be decided under the less strict principles of contract law—we must remand in this respect also.

The second breach of contract claimed was that Lionel did not cause a registration statement to become effective with respect to appellants' stock within a reasonable time. The district court held that both Hathaway and Lionel filed registration statements within the time they were obliged to do so, and that the former's was withdrawn on account of the merger. It also found that, while Lionel's registration statement became effective after three amendments some 51 weeks after it was filed, this was not an unreasonable length of time, since Lionel was cooperative and the law firm representing it before the SEC was diligent and competent.

We disagree with the district court in respect to this second alleged breach. To the extent that the delay of one year occurring before the S-1 became effective was a result of the originally misleading interim statement accompanying the S-1, the delay may well have been unreasonable. There was expert testimony that six to eight weeks was all that should have been necessary to effectuate the S-1 since much of the work going into it had al-

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12 Appellants also claimed that the filing of an S-1 by Lionel did not really constitute a filing since it contained a materially misleading financial statement. In our treatment of the case this question need not be resolved.

ready been done by Hathaway and in connection with the proxy solicitation on the merger vote. In regard to the extent to which delay may have been precipitated by or contributed to by the misleading interim statements, both the findings and the evidence seem to be insufficient. One of the reasons for the delay stated by the court (in accord with the testimony of Lionel's SEC lawyer) was that based on preliminary figures that Lionel developed with regard to its year-end (1961) results, it became likely that amendment with a year-end audit would be required. Developing the audit, of course, took some additional time (during which a comparison of 1961 with the latest, i.e., 1962, figures also became required). But one of the reasons for the bad-looking year-end figure was that the interim statements filed with the S-1 had not truly reflected the worsening financial situation that appears to have been developing through the first half of 1961 while accelerating in the second half. Moreover, while we have said that there was insufficiency of proof to show that the interim statement was misleading in respect to inventory write-downs and sales returns and allowances (and reserves), the write-downs were ultimately rather huge in amount and whatever it was that brought them about may not necessarily be used to justify the delay in filing an effective registration statement that occurred. On remand these issues may be better explored, and the findings in respect to them stated in greater depth.

The third breach claimed was that Lionel did not maintain effective registration for 24 months within the meaning of Hathaway's obligation to appellants to which by the merger Lionel had succeeded. The trial court held, however, that since the failure to maintain effectiveness was due to the accountants' "unwillingness to certify the necessary Financial Statements because of Lionel's accumulating losses" and the institution of a lawsuit in the

state courts of New York (said to have been by the appellants here on the same general grounds claimed in this action), 345 F. Supp. at 666,[13] there was, in the district court's view, no indication that Lionel had not used its "best efforts" to maintain effectiveness, which is all that it was required to do.

Much the same may be said of the alleged third breach as of the second. The court below found that to a certain extent the failure to maintain effectiveness of the registration was owing to the accountants' unwillingness to certify the necessary financial statements. According to the 1962 annual accountants' report that unwillingness was based upon the failure of the company to maintain the net working capital required under the indenture covering its 5½ per cent convertible subordinated debentures and "the possible failure to observe other indenture covenants." Again, however, to the extent to which that unwillingness was precipitated or contributed to by the misleading interim statements, or to faulty information conveyed by management to the certifying accountants, there may have been an omission to use "best efforts" to maintain effec-

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13 The lawsuit was apparently brought on April 2, 1963, and was dismissed on May 11, 1966, for lack of prosecution. Appellee asserts it in bar here. Appellants claim that Lionel subsequently retained their lawyer (*cf. Emle Industries, Inc.* v. *Patentex, Inc.*, No. 72-2048 (2d Cir., May 9, 1973)), and that he told the New York Stock Exchange at a Lionel delisting hearing that the state suit had been abandoned. In any event, the instant federal action was instituted by other counsel at or about the time of the dismissal of the state action in 1966, and after discovery the case was not tried under the old master calender system until June 4, 1971, and not decided until June 21, 1972. The district court did not reach the questions of laches, estoppel, abandonment and expiration of the statute of limitations, *see Sack* v. *Low*, No. 72-2327 (2d Cir., Apr. 13, 1973), slip op. at 2872-80, raised by appellee here, but these defenses will be available on remand. *Cf. Modrey* v. *American Gage & Machine Co.*, No. 72-1534 (2d Cir., May 1, 1973), slip op. at 3247.

tiveness. Here too on remand the issue may be explored in greater depth.

While the parties seek to have us rule on the additional defenses of abandonment, laches, estoppel and the running of the statute of limitations, these are all issues which the district court failed to reach, and absent specific findings we are not inclined to uphold or reject any of these defenses. *See* note 13, *supra*.

Reversed and remanded for findings in accordance with this opinion.

MULLIGAN, *Circuit Judge* (concurring):

While I concur in the reversal and remand here, I am not satisfied that the test of culpability under Rule 10b-5 has been articulated adequately in the majority opinion. Judge Oakes adopts the standard explicated in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, slip op. 4897 (2d Cir., March 16, 1973), in the opinions of Judges Timbers and Mansfield, and characterizes it as something short of specific intent and something more than mere negligence. In fact, the latest statement of the rule is in the *en banc* opinion of Judge Moore for this court in *Lanza* v. *Drexel & Co.*, slip op. 3033 (2d Cir., April 26, 1973), where we said: "In sum, we believe that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5." (id. at 3090). Footnote 98 indicates the obvious—that in determining the liability of a defendant, his corporate responsibilities must be taken into consideration.

Since this is the latest statement of the rule of this circuit and the *en banc* was granted primarily to clarify the rule, I see no reason at all for relegating it here to a list of some seven prior cases which we advise the court below to consider. I would now abide by the rule we so recently adopted.

REPUBLIC TECHNOLOGY FUND, INC., etc., Plaintiff,

v.

The LIONEL CORPORATION, Defendant.

The NEW ENGLAND INDUSTRIES, INC., etc., Plaintiff,

v.

The LIONEL CORPORATION, Defendant.

Nos. 66 Civ. 1523, 66 Civ. 1992.

United States District Court,
S. D. New York.
June 12, 1972.

Orans, Elsen & Polstein, New York City, for plaintiffs; Sheldon H. Elsen and Lewis Shapiro, New York City, of counsel.

Olwine, Connelly, Chase, O'Donnell & Weyher, New York City, for defendant; James E. Tolan, Judith S. Kaye, Paul D. Freeman, Richard F. Youmans, New York City, of counsel.

OPINION

BONSAL, District Judge.

These two actions, which were tried together by the court without a jury, arise out of the merger of Hathaway Instruments, Inc., into The Lionel Corporation, which merger became effective on November 6, 1961. Plaintiff in 66

Civ. 1523, Republic Technology Fund, Inc. ("Republic"), was incorporated under the laws of Delaware and has its principal place of business in California. Plaintiff in 66 Civ. 1992, The New England Industries, Inc. ("NEI"), was incorporated under the laws of Connecticut and has its principal place of business in New York. Both plaintiffs are investment funds. The defendant in both actions, The Lionel Corporation ("Lionel"),[1] was incorporated under the laws of New York and has its principal place of business in New Jersey. Plaintiffs are former shareholders of Hathaway, and as a result of the merger of Hathaway into Lionel, received shares of Lionel convertible preferred stock in exchange for their shares of unregistered Hathaway common stock.

The gravamen of plaintiffs' complaints is that Lionel's unaudited Financial Statements for the six-month period ending June 30, 1961, contained in the Hathaway proxy statement on which they relied in exchanging their shares, were materially false and misleading in that they understated Lionel's losses for

1. Lionel is a multi-line corporation which designs, manufactures and markets model electric trains and other toys; electronic instruments and components; radiation detection and measuring devices; missile parts and air-frame sections; and parachutes for recovery and deceleration chutes for jet aircraft. (Plaintiffs' exhibit 17, p. 21.)

this period. Plaintiffs sue under Section 17 of the Securities Act of 1933, 15 U.S. C. § 77q, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (b) and Rule 10b–5 promulgated thereunder, and Section 14 (15 U.S.C. § 78n) and Rule 14a–9 promulgated thereunder. Jurisdiction is based on Section 22(a) of the Securities Act of 1933, 15 U.S.C. § 77v, and Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

By way of pendent jurisdiction in both actions and diversity of citizenship in the Republic action, plaintiffs allege that Lionel breached its contractual obligation to register under the Securities Act of 1933 the shares of Lionel preferred stock which they received in exchange for their unregistered shares of Hathaway common stock.

On July 8, 1960, Republic purchased 25,000 shares of the unregistered Hathaway common stock, and on March 15, 1961 purchased 25,000 additional shares. On March 15, 1961, NEI purchased 15,000 shares of unregistered Hathaway common stock.

In June of 1961, Lionel and Hathaway entered into merger negotiations culminating in a merger agreement. The merger became effective on November 6, 1961.

The Agreement of Merger, which was attached to the Hathaway proxy statement as Exhibit A, provided for the "conversion" of the 1,022,727 shares of Hath-

away common stock into Lionel 3¾ non-cumulative convertible preferred stock at the rate of one share of Lionel preferred for each three shares of Hathaway common. In accordance with the Agreement of Merger, Republic exchanged 50,000 shares of Hathaway common for 16,667 of Lionel preferred, and NEI exchanged 15,000 shares of Hathaway common for 5,000 shares of Lionel preferred.

The Hathaway proxy statement included Financial Statements for both companies as well as pro forma Financial Statements for the merged company. Lionel's Financial Statements included audited financial figures for the five-year period ending December 31, 1960, and unaudited financial figures for the six-month periods ending June 30, 1960, and June 30, 1961. Lionel's unaudited Consolidated Statement of Income for the six-month period ending June 30, 1961, showed a net loss of $107,996 ($.18 per share) as compared with a profit of $655,011 ($.48 per share) for the corresponding period in 1960. The pro forma net income statement for the merged company for the six-month period ending June 30, 1961, showed a net income of $245,311 ($.08 per share).

The loss shown by Lionel for this period was the beginning of a long period of financial adversity. Lionel showed a loss for the year 1961 of $2,532,277; for

the year 1962, of $4,871,209; and for the year 1963, of $6,537,525. For the year 1960, Lionel showed a net income of $862,897.

An action was instituted on April 2, 1963, in the New York Supreme Court, which included the plaintiffs and which was a purported class action seeking substantially the same relief here sought. The New York action was dismissed on May 11, 1966, for lack of prosecution. The instant actions were instituted as purported class actions on May 25, 1966 (Republic) and July 6, 1966 (NEI). On November 7, 1966, Judge Weinfeld denied plaintiffs class action status without prejudice. At trial, plaintiffs made no attempt to have the case treated as a class action.

In view of the deteriorating financial condition of Lionel, it is understandable that plaintiffs should seek some way to recoup their loss. Indeed, it may be that Lionel's mounting losses resulted, in part, by mismanagement. However, only Lionel is named as a defendant, so that any recovery from Lionel will be paid out of its assets at the expense of its other stockholders. This makes it essential that the plaintiffs prove their contentions by a fair preponderance of the evidence.

At trial, plaintiffs relied on the expert

testimony of Irving L. Duchan,[2] a certified public accountant. Mr. Duchan is a partner in J. H. Cohen and Company, an accounting firm which audits publicly held corporations. Mr. Duchan taught accounting at the School of Business of the City College of New York and has testified on numerous occasions as an accounting expert.

At trial, Lionel relied on the testimony of Kermit Easton, a certified public accountant and a partner of S. D. Leidesdorf & Co. ("Leidesdorf"). Leidesdorf was Lionel's auditor from the early

2. Mr. Duchan testified that he examined the following:
   1. Hathaway Proxy Statement (Pl. Ex. 17)
   2. Lionel Annual Report for 1961 (Pl. Ex. 26)
   3. Registration Statement filed by Lionel Sept. 28, 1961 (Pl. Ex. 60)
   4. S. D. Leidesdorf & Co. work papers, including:
      Lionel six-month adjusting entries (Pl. Ex. 52)
      Lionel June 30, 1961 consolidated statements (Pl. Ex. 53)
      Lionel June 5, 1961 trial balance (Pl. Ex. 54)
      Lionel December 31, 1961 adjusting entries (Pl. Ex. 55)
      Lionel December 31, 1961 consolidated statements (Pl. Ex. 56)
      Lionel December 31, 1961 trial balance (Pl. Ex. 57)
      Summary Lionel year-end adjustments as result of year-end audit or during fourth quarter (Pl. Ex. 58)

1940's when Lionel became a publicly held corporation, until the mid 1960's. Mr. Easton is a member of the faculty of the Northeastern University Center for Management Development, where he teaches corporate financial reporting, has appeared on Practicing Law Institute Panels, and has lectured before the American Management Association. In 1960 Mr. Easton was a managing accountant on the Lionel audit. In 1961 he became the senior managing accountant, and he subsequently became a partner of the firm. Mr. Easton testified both as to his participation in the preparation of the Financial Statements and as an accounting expert.

Plaintiffs contend that Lionel's unaudited financial figures for the six-month period ending June 30, 1961, were false and misleading in that Lionel failed to make necessary adjustments in the following items:

(1) Inventory
(2) Sales returns and allowances
(3) Reserve for bad debts
(4) Goodwill
(5) Research and development
(6) Selling, advertising and service expenses
(7) Miscellaneous

Mr. Duchan testified that at year-end, Lionel made adjustments in these items for the full year 1961 of over $2.-

000,000 [3] and that, in his opinion, a substantial portion of these adjustments should have been reflected in the June 30 Financial Statements.

Lionel's expert, Mr. Easton, disagreed. He testified that, based on his familiarity with Leidesdorf's audit for 1961, its participation in the June 30 unaudited Financial Statements and its preparation in April 1962 of the schedule (Pl. Ex. 58) analyzing Lionel's losses for the year 1961, in his opinion the June 30, 1961 Financial Statements were accurate. In Mr. Easton's opinion, the fact that adjustments were made for the entire year did not mean that such adjustments were required in the six-month Statements in view of the seasonal nature of much of Lionel's business. Mr. Easton testified that the June 30 Financial Statements were prepared in accordance with the same generally accepted accounting principles used in its year-end Statements and in its Financial Statements for prior years, and that where Lionel made changes in its accounting procedures, they were reflected in the notes to the Financial Statements.

The court turns to a consideration of

3. The following adjustments were recorded as at December 31, 1961:

Inventory	$1,466,778
Sales returns and allowances	106,000
Deferred research and development	390,000
Deferred selling, advertising and service expenses	249,000
	$2,211,778

the several items as to which plaintiffs contend adjustments should have been made in the June 30 Statements.

Inventory

Lionel did not take a physical inventory for its June 30 Financial Statements. Instead, Lionel estimated its inventory by adding purchases, direct labor and factory overhead to its December 30, 1960 inventory and deducting therefrom the estimated costs of goods sold (Pl. Ex. 17, pg. F–28, Note C). Mr. Duchan testified that proper interim reporting required that Lionel consider making adjustments to reflect obsolescence, raw material price variance, shrinkage, and unlocated difference between book and physical inventory.[4]

Mr. Duchan testified that on the basis of the industry toy show in March, Lionel

4. At year-end, Lionel made inventory adjustments of $726,776. for its Toy and Train Division, and $740,000. for its Electronics Divisions. The adjustments made for the Toy and Train Division were as follows:

Obsolescence	$252,830
Raw material price variance	$140,000
Shrinkage	$ 77,946
Unlocated difference between book and physical inventory	$256,000

should have been able to determine which lines might be "losers" and to make a partial adjustment for obsolescence at June 30. Mr. Easton disagreed, testifying that it was Lionel's experience that less than 10% of its toy sales were related to orders picked up at the March toy show and that this did not provide a sufficient basis for adjusting inventory due to obsolescence. Mr. Duchan could draw no conclusion from the documents which he had examined as to whether or not Lionel should have made an adjustment for obsolescence in the June 30 Statements. (Tr. 206)

As to raw material price variance, it was Mr. Duchan's opinion that by June 30 Lionel would have purchased enough raw materials to make a partial adjustment for raw material price variance. However, there was no evidence presented from which the need of such an adjustment could be determined, or any evidence as to Lionel's raw material purchases during the six-month period.

With regard to shrinkage and unlocated difference between book and physical inventory, while Mr. Duchan suggested that on the basis of prior physical inventories Lionel should have estimated an adjustment for these items as at June 30, Mr. Easton pointed out that the only way to ascertain shrinkage and unlocated difference between book and physical inventory is to take a physical inventory, and plaintiffs do not contend

that Lionel should have taken a physical inventory before issuing its June 30 Financial Statements. Mr. Duchan suggested that Lionel had a history of inventory variations in the early part of each year, but there was no evidence to support this suggestion.

Mr. Duchan also suggested that the failure at midyear to make inventory adjustments for the Telerad Division, which had a year-end inventory adjustment of $540,000, resulted in Telerad's showing a profit of $28,000 for the first six months on $480,000 of sales, and a loss of $551,000 for the second six months on $889,000 of sales. Mr. Easton testified that at June 30, Lionel considered Telerad's inventory to be saleable and therefore did not write it down, and that the mere fact that substantial inventory adjustments were made in the second half of the year does not establish that such adjustments were required to be made at June 30.

Sales Returns and Allowances

At year-end, Lionel made adjustments for sales returns and allowances in the amount of $54,000 for the Toy and Train Division, and $52,000 for the Airex Division. Mr. Duchan thought that part of these adjustments should have been made in the June 30 Statements, particularly with respect to Airex, which Mr. Duchan believed had a different seasonal pattern than the Toy and Train Division. How-

ever, Mr. Easton pointed out that on the books of Lionel, sales returns and allowances were entered when they occurred and were matched against the sales out of which they arose. The Airex sales returns and allowances reflected in the year-end adjustment related to sales of sporting goods imported from Japan which were sold during the Christmas season of 1961. Therefore, because of the seasonal (Christmas) nature of the business of both divisions in 1961, most of the sales returns and allowances were made in early 1962 and reflected in the 1961 year-end Statements. For the same reason, most of the sales returns and allowances during the first six months of 1961 would have been reflected in the 1960 year-end Statements.

Reserve for Bad Debts

At June 30, Lionel showed a reserve of $72,000 for "Doubtful Accounts" against Accounts Receivable of $3,312,000 (2.1%), whereas for the year 1961, Lionel showed a reserve of $315,000 for "Doubtful Accounts, Discounts, Returns and Allowances" against $3,649,000 of Accounts Receivable (8.5%). Mr. Duchan suggested that the difference in the reserve indicated that the reserve made at June 30 was inadequate. Mr. Easton again disagreed, stating that on the basis of Leidesdorf's experience as Lionel's auditor and the discussions Leidesdorf personnel had with Lionel personnel,

Leidesdorf was satisfied that the June 30 reserve was adequate. He pointed out that the two reserves were not comparable since the year-end reserve included discounts, returns and allowances as well as doubtful accounts.

Goodwill

Lionel's audited Balance Sheets for the years ending December 31, 1960, and December 31, 1961, contained an item, "Excess of Cost of Acquisition of 40,000 Shares of Common Stock of Anton-Imco Electronics Corp. Over Underlying Book Amount at Date of Acquisition . . . $998,076." It was agreed that this item represented the goodwill of Anton-Imco. The same figure, $998,076, was included in Lionel's unaudited Balance Sheet for June 30, 1961. Mr. Duchan noted that Anton-Imco showed an operating loss of $189,000 at June 30, 1961, and was of the opinion that the goodwill item should have been written down. It appears that Anton-Imco was acquired by Lionel in 1960, and at June 30, 1961 was developing a currency recognizing device. In Lionel's opinion, the prospects of success of this device warranted no diminution in the goodwill item, and Mr. Easton testified that at the end of the year 1961, while a write-down was discussed, Leidesdorf agreed with Lionel that no reduction need be made, although Anton-Imco showed a year-end loss of $724,000.

Research and Development

At year-end, Lionel wrote off $390,000 of deferred research and development expenses on projects which no longer had any commercial value. Mr. Duchan suggested that Lionel arbitrarily waited until year-end to review research and development projects and, in view of the year-end adjustments, was of the opinion that as at June 30 an adjustment was called for. Mr. Easton testified that Lionel reviewed its research and development projects as at June 30. When Loidesdorf made the year-end audit, they found nothing to indicate that an adjustment for research and development should have been made as at June 30. Mr. Duchan pointed out that Lionel changed its policy, for financial reporting purposes, with respect to treatment of engineering and design costs in the year 1960 and that, had it not done so, a greater loss would have been shown in the June 30 Financial Statement. However, as pointed out by Mr. Easton, this fact was fully disclosed in Note J to the June 30 Financial Statements.

Selling, Advertising and Service Expenses

The June 30 unaudited Balance Sheet showed, in "Deferred Charges", an item for selling, advertising and service ex-

penses deferred, in the amount of $449,-245, which item was eliminated in the year-end Statement. A schedule prepared by Leidesdorf in April, 1962 (Pl. Ex. 58) shows an item of $249,000 as "[d]eferred selling, advertising and service expenses deferred as at September 30, 1961, which should have been expensed at September 30, 1961, if the budgeted sales and expense used in the September 30, 1961, computation of the deferral were actual sales and expense for the year 1961." Mr. Duchan thought that at least part of the $249,000 should have been expensed at June 30, 1961, and would have been if Lionel had considered whether actual sales were running less than projected sales. The issue raised is whether the relationship between Lionel's actual sales and projected sales warranted it carrying the $449,245 figure as at June 30. Mr. Easton testified that on the basis of discussions with Lionel personnel and its own review for reasonableness, Leidesdorf was satisfied that as at June 30 Lionel's actual and projected sales were in line and its sales projections were reasonable. Mr. Easton further testified that the disparity between actual and projected sales did not arise until after September.

Miscellaneous

There was evidence as to several small items which plaintiffs allege were reflected in the June 30 Financial State-

ments and which involved the question as to whether they related to the six-month period ending June 30, 1961, or whether they related to a different accounting period. There was some difference of opinion between Mr. Duchan and Mr. Easton on these items[5] but, in any event, they would not have materially changed the overall picture and there is no showing that any of them involved a material misrepresentation.

[1] Plaintiffs have not established by a fair preponderance of the evidence that the June 30 Financial Statements were materially false or that Lionel omitted to state any material fact necessary to make the Statements not false or misleading. See Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 799 (2d Cir. 1969); Abramson v. Nytronics, Inc., 312 F.Supp. 519, 524 (S.D.N.Y.1970);

5. These items are:

1. $51,369 included as other income in Lionel's Consolidated Statement of Income for the six-month period ending June 30, 1961.

2. $24,000 for sales returns shown as a credit on Lionel's trial balance as at June 30, 1961.

3. $19,233.68 for cooperative department store advertising expenses shown as a credit on Lionel's trial balance as at June 30, 1961.

The evidence does not show how items 2 and 3 were reflected in the Financial Statements, if indeed they were.

Richland v. Crandall, 262 F.Supp. 538, 552 (S.D.N.Y.1967).

While Mr. Duchan was of the opinion that adjustments should have been made in the Lionel June 30 Financial Statements, he could not indicate the amount of these adjustments. Therefore, if in fact any adjustments were required, the court has no basis for finding "whether the fact[s] claimed to have been misstated or omitted [were] of such a nature that it could normally be expected to lead a reasonable stockholder [of Hathaway] not to vote in favor of the [merger] proposal . . . ." Richland v. Crandall, *supra* at 553; Mills v. Electric Auto-Lite, 396 U.S. 375, 384, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970); Crane Co. v. Westinghouse Air Brake Co., *supra*. While it is true, as contended in plaintiffs' brief, that approximately $30,000 of adjustments would have decreased the pro forma combined net income of Lionel and Hathaway from 8¢ per share to 7¢ per share, the Hathaway stockholders would have looked primarily to Lionel's Financial Statements in considering the merger proposal.

The Lionel six-month income statement which plaintiffs charge was false and misleading shows a net loss of $107,996 as against net income for the comparable period in the year 1960 of $655,011. There was no evidence that the accounting principles followed in the preparation of the six-month statement

for 1961 differed from those followed in the preparation of similar statements for 1960 or prior years. Clearly, within this context plaintiffs have failed to carry their burden of proof as to materiality. Compare Bowman & Bourdon, Inc. v. Rohr, 296 F.Supp. 847 (D. Mass.1969), aff'd, 417 F.2d 780 (1st Cir. 1969).

[2] Mr. Easton's testimony satisfied the court that the Lionel personnel who prepared the June 30 Financial Statements with the assistance of Leidesdorf did not know (nor should they have known) that the Statements were false or misleading, and there is no evidence to show that Lionel sought to perpetrate a fraud in preparing the Statements for use in Hathaway's proxy statement. Granting a difference of opinion between Easton and Duchan as to the accounting principles involved, the court can make no finding of any form of scienter on the part of Lionel. See Globus v. Law Research Service, Inc., 418 F.2d 1276, 1290 (2d Cir. 1969); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968); Astor v. Texas Gulf Sulphur Co., 306 F.Supp. 1333, 1343 (S.D.N.Y.1969). Indeed, the evidence is to the contrary.

[3] The instant case is clearly distinguishable from Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d Cir. 1952). There, the Court of Appeals

found that Kaiser-Frazer represented that it had earnings of about $4,000,000 in December, 1947, when in fact its earnings for that month were only $900,000, the difference being accounted for by an inventory write-up made by the company which should have been allocated over prior periods as well as December in determining the December earnings. Therefore, the court held that the Statement of December earnings was untrue on the basis of the facts known to the company at the time it was made. There is no evidence here that the Lionel June 30 Financial Statements were untrue on the basis of facts known to Lionel at the time they were made.[6]

6. In addition to alleging violations of Section 17 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 promulgated thereunder, plaintiffs allege a violation of Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a–9 promulgated thereunder. Since Hathaway's common stock was not registered under Section 12 of the Securities Exchange Act of 1934, the Hathaway proxy statement was not subject to Section 14 and Rule 14a–9 of the Act. Moreover, plaintiffs have failed to establish by a fair preponderance of the evidence that the proxy statement was materially false or that it omitted material facts necessary to make the statement not false or misleading.

Contract Issue

On July 8, 1960, Republic purchased 25,000 shares of unregistered common stock of Hathaway at a price of $20.75 a share. The contract provided that if at any time after 12 months from the date of the contract Republic should determine to register its Hathaway stock under the Securities Act of 1933, Hathaway would use its "best efforts" to register the stock at Republic's expense, and Hathaway covenanted that the Registration Statement would comply with Section 10 of the Securities Act and would not include any false statements or fail to state material facts.

On March 15, 1961, Republic purchased 25,000 additional unregistered shares of Hathaway stock, and NEI purchased 15,000 shares of Hathaway unregistered common stock. In the letters covering these sales, Hathaway represented that it intended to file a Registration Statement on or before May 15, 1961 covering its convertible subordinated debentures and the common stock issuable upon conversion of these debentures. Hathaway agreed that it would use its "best efforts" to include in the Registration Statement the shares acquired by Republic and NEI "to the end" that their shares would be registered and the Registration Statement would remain effective for a period of not less than 24 months. On March 27,

1961, Republic wrote Hathaway that it would appreciate having all its shares registered. On May 5, 1961, Hathaway filed a Registration Statement with the Securities and Exchange Commission ("SEC") covering its debentures and its common stock (including plaintiffs' shares).

Hathaway commenced negotiations for a merger with Lionel. On June 8, 1961, (having obtained the consent of a majority of its debenture holders) Hathaway asked the SEC for permission to withdraw its Registration Statement because of the pending merger. The SEC withheld such permission until after September 28, 1961, on which date Lionel filed a Registration Statement which included the shares of Lionel preferred stock which would be issued in exchange for the unregistered shares of Hathaway common stock. The merger between Hathaway and Lionel originally contemplated an exchange of Lionel common for Hathaway common but after considerable negotiation the final Agreement of Merger provided for the exchange of Lionel preferred for Hathaway common.

Hathaway merged into Lionel pursuant to an Agreement of Merger dated as of September 15, 1961, which was executed by the parties on October 19, 1961, and approved by the stockholders of both companies on October 25, 1961.

As a result of the merger, Lionel succeeded to Hathaway's obligations to the plaintiffs insofar as they remained applicable. In addition, Article XIV of the Agreement of Merger provided that Lionel would file a Registration Statement with the SEC on or before October 15, 1961 covering Hathaway's debentures and the common stock into which such debentures could be converted and "such other of its [Hathaway] $1.00 par value common stock as Hathaway may by previous agreement be legally obligated to register."

The history of Lionel's Registration Statement, which was originally filed with the SEC on September 28, 1961, was testified to in detail by Peter E. Panarites, whose Washington, D. C. law firm represented Lionel. The work was done at Lionel's direction and included, in the first instance, the preparation of an S–1 Registration Statement (covering debentures, preferred and common stock) and a proxy statement for Lionel in connection with the Hathaway merger. In July, Panarites' firm was instructed to stop work as there had been a hitch in the merger negotiations. Four weeks later, after the merger deal was changed from common for common to preferred for common, Panarites' firm resumed work on both the S–1 and the Lionel proxy statement. The Lionel proxy statement was filed in August and cleared by the SEC in September, 1961.

The S-1 Registration Statement was filed on September 28, 1961, it being contemplated that a number of amendments would be required in connection with the Financial Statements and to reflect the final merger terms. Panarites' firm undertook to obtain detailed information as to the Hathaway stockholders who intended to sell their shares when the registration became effective. It also became necessary to file third-quarter financials. Amendment No. 1 to the S-1 was filed on December 19, 1961, and in January, 1962 the SEC submitted a list of comments which required a second Amendment. While work was proceeding on Amendment No. 2, it appears that Lionel's year-end losses for 1961 made it necessary to include year-end 1961 Financial Statements. Following conferences with the SEC, Lionel agreed to furnish audited year-end figures for 1961. The Hathaway stockholders were advised accordingly.

The Lionel year-end 1961 audit was completed on or about March 15, 1962. The audit of the Hathaway figures took some time because of the number of auditors involved. Lionel's Amendment No. 2 to its S-1 was filed in May and included first quarter unaudited financials. Thereafter, further communication was had with the Hathaway stockholders to determine their intent to sell. The SEC reported its comments on July 5 and requested a comparative earnings

statement for the first six months of 1961 and 1962, which was completed during August. Amendment No. 3 to the S–1 was filed on September 14, 1962, and the Lionel S–1 became effective on September 21, 1962.

During early 1963 it appeared that Lionel had suffered another substantial loss in 1962, and it was determined to suspend sales under the Registration Statement and Prospectus until year-end audited financials for the year 1962 could be furnished. The effectiveness of the Registration Statement was suspended in March, 1963. At this point, Lionel was impaled on the horns of a dilemma. The SEC required certified 1962 year-end Financial Statements. Leidesdorf, Lionel's auditor, was unable to certify these Financial Statements because in its opinion Lionel, as a result of its losses, had breached certain restrictive covenants in the agreement under which its debentures were issued, which required a consolidated working capital of not less than 125% of its consolidated funded debt. As at December 31, 1962, there was a deficiency of approximately $1,200,000 in the required consolidated working capital. In addition, Leidesdorf was aware that on April 2, 1963, an action had been instituted in the State court against Lionel on behalf of the holders of its preferred stock, alleging that Hathaway, and later, Lionel, had breached their contractual obliga-

tions to file a Registration Statement, and that there were violations of the Securities Act and the Securities Exchange Act committed in connection with the Hathaway proxy statement. The New York action, which it is stated was instituted by the plaintiffs here, was dismissed on May 11, 1966, by Justice Silverman for lack of prosecution.

Mr. Panarites testified that, following the suspension of the Registration Statement, his firm undertook negotiations with the SEC with the view to obtaining "no action" letters for those former Hathaway stockholders who wished to sell their Lionel preferred stock.

Plaintiffs contend that Lionel breached its contractual obligations on three grounds:

"1. Lionel did not comply with its obligation under Article XIV of the Agreement of Merger because the only registration statement for the registration of plaintiffs' stock which it filed before October 15, 1961 was materially defective, in that it contained materially misleading financial information (the interim figures of June 30, 1961).

"2. Lionel did not cause a registration statement to become effective with respect to plaintiffs' stock within a reasonable time.

"3. Lionel did not maintain effective registration for plaintiffs' stock for 24

months, within the meaning of Hathaway's March 15, 1961 covenant, to which Lionel succeeded."

The first ground has already been disposed of because the court has found that the June 30, 1961 Statements were not materially misleading.

[4] With respect to the second ground, both Hathaway and Lionel filed Registration Statements within the time they were obliged to do so. Hathaway agreed to file a Registration Statement on or before May 15, 1961, and filed the Statement on May 5, 1961. The reason for withdrawing this Statement was the merger with Lionel, of which plaintiffs were fully aware, and in which they participated by exchanging their Hathaway common stock for Lionel preferred. Article XIV(b) of the Agreement of Merger required Lionel to file a Registration Statement on or before October 15, 1961, and Lionel filed the Registration Statement on September 28, 1961, which became effective on September 21, 1962.

In view of the financial problems hereinabove referred to and the testimony adduced at the trial, plaintiffs have not established that the Lionel Registration Statement and Prospectus did not become effective within a reasonable time. Plaintiffs' expert, Mr. Friedman, conceded that he had known of situations where Registration Statements never

became effective even though those preparing them were diligent and competent (Tr. 304–305). Mr. Panarites' testimony indicates that he and his firm were diligent and competent, and he testified that Lionel was at all times cooperative in furnishing information as required.[7]

[5] As to the third ground, on March 15, 1961, Hathaway agreed to use its "best efforts" to the end that plaintiffs' Hathaway shares would be registered and the Registration Statement would remain effective for a period of not less than 24 months. Assuming, *arguendo*, that this obligation under the Agreement of Merger applied to plaintiffs' Lionel preferred shares, Lionel's obligation was only to use its "best efforts". It did not promise plaintiffs that the Registration Statement and Prospectus would

7. In their brief, plaintiffs rely on Kupferman v. Consolidated Research & Mfg. Corp., 53 F.R.D. 387 (S.D.N.Y.1971) for the proposition that in the spring of 1961 "it would have taken only some six weeks after filing for a registration statement to become effective." On the contrary, Judge Levet found (Finding 32) that it would have taken a *minimum* of six weeks to prepare and file a post-effective amendment, and an *additional six weeks* for the SEC to review the amendment and declare it effective. Of course, if the SEC requested an additional amendment, as here, more time would be required.

remain effective for 24 months. Plaintiffs' expert, Mr. Friedman, testified that the term "best efforts" means that:

> "the person obligated to prepare and file the registration statement will set to work diligently and competently to do everything that would have to be done to make the registration statement effective so that in the normal course of events his best efforts would produce effectiveness, the best efforts, in my judgment, being limited only by external causes over which the person preparing the registration statement would have no control."

Defendant's expert, Mr. Panarites, testified, in part: "Best efforts, as far as I am concerned, imposes a requirement that the registration statement not be permitted to lie fallow at the SEC."

Here, "best efforts" was to be directed to maintaining the effectiveness of the Registration Statement and Prospectus for 24 months. The failure to maintain the effectiveness of the Registration Statement and the Prospectus was due to Leidesdorf's unwillingness to certify the necessary Financial Statements because of Lionel's accumulating losses and the institution of the New York lawsuit. This determination of Leidesdorf was beyond Lionel's control. Of course, had not Lionel suffered heavy losses during the period, it would not have been in the

dilemma in which it found itself. If such losses were due to mismanagement, plaintiffs may have a remedy against the company and its officers and directors. However, on the evidence, it cannot be said that Lionel failed to use its best efforts to continue the effectiveness of the Registration Statement and Prospectus for a period of 24 months.

Since the court concludes that plaintiffs have failed to prove their case on the merits, it does not reach the defenses of laches, estoppel, abandonment and the statute of limitations.

The foregoing constitutes the court's findings of fact and conclusions of law. Fed.R.Civ.P. 52(a).

The Clerk may enter judgment dismissing the complaints with costs.

It is so ordered.



Judgment of the Court of Appeals.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the seventeenth day of July one thousand nine hundred and seventy-three.

Present: Hon. Paul R. Hays,
Hon. William H. Mulligan,
Hon. James L. Oakes,
Circuit Judges.

72-1901
72-1902

Republic Technology Fund, Inc., on behalf of itself and all others similarly situated,
Plaintiff-Appellant,

v.

The Lionel Corporation,
Defendant-Appellee.

The New England Industries, Inc., on behalf of itself and all others similarly situated,
Plaintiff-Appellant,

v.

The Lionel Corporation,
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and reversed in part and that the actions be and they hereby are remanded to said District Court for further proceedings in accordance with the opinion of this court.

A. Daniel Fusaro
Clerk

Order of Court of Appeals Denying Petition for Rehearing.

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the sixth day of September, one thousand nine hundred and seventy-three.

Present:

HON. PAUL R. HAYES,
HON. WILLIAM H. MULLIGAN,
HON. JAMES L. OAKES,
Circuit Judges

72—1901-2

REPUBLIC TECHNOLOGY FUND, INC., on behalf of itself and all others similarly situated,

Plaintiff-Appellant,

v.

THE LIONEL CORPORATION,

Defendant-Appellee.

Order of Court of Appeals Denying Petition for Rehearing.

THE NEW ENGLAND INDUSTRIES, INC., on behalf of itself and all others similarly situated,

Plaintiff-Appellant,

v.

THE LIONEL CORPORATION,

Defendant-Appellee.

A petition for a rehearing having been filed herein by counsel for the appellee,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. DANIEL FUSARO,
Clerk

Order on Petition for Rehearing With Suggestion for Rehearing In Banc.

• • •

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellee, and no active circuit judge having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. DANIEL FUSARO,
Clerk.

Excerpts From Hathaway Proxy Statement (Plaintiffs' Exhibit 17)

THE LIONEL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

"The following statements present the consolidated results of operations of The Lionel Corporation and subsidiaries, revised to include the operating results of Anton-Imco Electronics Corp. and its subsidiaries for the three years (1957, 1958 and 1959), prior to acquisition, in accordance with the pooling of interests principle of accounting. See Note A of the notes to financial statements. To the extent that the statements relate to the five years ended December 31, 1960, they have been examined by S. D. Leidesdorf & Co., independent certified public accountants, as set forth in their report included elsewhere herein, except as to the combined statement of income of Intercontinental Manufacturing Company, Inc. and Anton Electronics Laboratories, Inc. (name changed to Lionel Electronic Laboratories, Inc. on March 16, 1961) for the three years ended December 31, 1959, and the financial statements of Intercontinental Manufacturing Company, Inc. for the year ended December 31, 1960, which statements have been examined and reported upon by other independent certified public accountants, Haskins & Sells, as set forth in their report included elsewhere herein. The statements for the six-month periods ended June 30, 1960 and 1961 are unaudited. In the Company's opinion, all known adjustments have been made which are necessary to present fairly the consolidated results of operations for such unaudited periods. The consolidated results of operations for the six-month periods ended June 30, 1960 and 1961 are not necessarily indicative of the results of operations on an annual basis, principally because of the seasonal nature of some of the Company's operations. The following statements should be read in conjunction with the other consolidated financial statements, and the notes to financial statements, included elsewhere herein."

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

"On September 30, 1960, Lionel acquired the net assets of Anton-Imco Electronics Corp. for 331,788 shares of its common stock. Such shares were distributed pro-rata to the Anton-Imco shareholders, including Lionel which, prior to the execution of the purchase agreement, had acquired 40,000 shares or approximately 16% of the outstanding Anton-Imco stock for $1,300,000.

"Anton-Imco's assets with minor exceptions, consisted of all of the stock of two operating companies which now are Lionel subsidiaries. These are: Lionel Electronic Laboratories, Inc. (formerly known as Anton Electronic Laboratories, Inc.) and Intercontinental Manufacturing Company, Inc. The products of these subsidiaries are described below.

"Lionel Electronic Laboratories, Inc. (Radiation detection and measuring devices, electronic and electro-mechanical devices)—Founded in 1948, this company is engaged in the development and manufacture of vacuum tubes and other electronic and nuclear instruments and devices. From its inception until 1956, it was engaged in research and development relating to vacuum tubes to be used as sensors for the detection and measurement of radiation. In early 1956, its operations were converted to manufacturing and production.

"The products of this subsidiary include nuclear detectors and chambers for Alpha, Beta, Gamma and Neutron detection and measurement; printed circuits, connectors, relay sockets and precision potentiometers; rate meters, scalers, thickness gauges, density and level indicators and radiac calibrators. It has developed low background counters used by the Atomic Energy Commission and others for the detection of fallout, and its radiation de-

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

tectors have been used in artificial satellites launched by the United States. Its research and development department has been employed by the Atomic Energy Commission, Space Administration, Department of Defense, as well as by industry. All of Lionel Laboratories' sales are made by its officers, salesmen, and through manufacturers' representatives.

"This company recently designed and developed a currency recognizing device, several prototype models of which have been built up to this time. The device has not yet been marketed and there is no assurance at this time as to whether it will be a profitable item.

"Raw materials used by this subsidiary include stainless steel, glass, aluminum, ceramics, copper wire, plastic materials and molding compounds. It purchases components, such as transformers, transistors, capacitors and resistors. All of the raw materials and purchased parts used by Lionel Labs are readily available from a number of sources and Lionel Laboratories anticipates no difficulty in obtaining adequate supplies in the future.

"Intercontinental Manufacturing Company, Inc. (Aircraft and missile components)—Intercontinental, located at Garland, Texas (near Dallas), is engaged in the manufacture of components for missiles and the production of metal fabricated airframe sections and parts. Typical examples of the products which it manufactures are missile motor casings, blast tubes and nozzles, bomb racks, missile motor parts, airframe components, pressure tank and jet nozzle attachment. Intercontinental is a prime contractor for components of the Nike-Hercules missile, a subcontractor for the improved Honest John Missile and does various metal fabrication and assembly work for aircraft, missile and rocket producers. Intercontinental is currently

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

performing a $222,997 engineering study on the Littlejohn Missile System, less warhead. This prime contract includes fabricating of complete assemblies for static firing, (recently completed) and flight firing (assembly fabricating still in progress). The study is Intercontinental's first major engineering contract on a complete missile system.

"Organized in 1947 as a tractor and farm equipment manufacturer, Intercontinental, from 1951 to 1958, was engaged principally in the manufacture of aircraft parts and the assembly of airframe sections and components. In 1958, Intercontinental entered the missile field as a supplier of parts for the Jupiter missile. Since that time, the manufacture of aircraft and missile parts and components has constituted the principal part of Intercontinental's business which also includes the manufacture and sale of various pressure vessels for use in the vending machine industry. Intercontinental's sales are all made by company officers.

"Practically all raw materials used by Intercontinental are mill-type items such as alloy steel, forgings, castings, plate, bar and billet steel, aluminum and magnesium. It has encountered no difficulty in obtaining adequate supplies. Purchased components used by the Company are principally attachment materials such as rivets, bolts, fittings and other catalog-type items available from a number of sources."

Plaintiffs' Exhibit 17, Page 24

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

THE LIONEL CORPORATION

AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1960 (Audited)	June 30, 1961 (Unaudited)
Current Assets:		
• • •		
Other Assets:		
• • •		
Excess of Cost of Acquisition of 40,000 Shares of Common Stock of Anton-Imco Electronics Corp. Over Underlying Book Amount at Date of Acquisition—Note A	$ 998,076	$ 998,076
• • •		

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

THE LIONEL CORPORATION

AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

"Note A—Principles of Consolidation:

"All subsidiary companies are wholly-owned and their accounts (including those companies acquired in 1960 on a basis of pooling of interests—see below) are included in the accompanying consolidated financial statements after the elimination of intercompany items and transactions.

"In accordance with an agreement dated June 22, 1960, the Company purchased 40,000 shares of Anton-Imco Electronics Corp.'s common stock, par value $1 per share, for an aggregate purchase price of $1,300,000. The excess of cost over underlying book amount at date of acquisition amounted to $998,076. The Company has not adopted any policy of amortizing such excess.

"In accordance with an agreement dated in July 1960, the net assets of Anton-Imco Electronic Corp. (hereinafter referred to as "Anton-Imco") were exchanged for 331,788 shares of the Company's Common Stock, par value $2.50 per share. The aforementioned 331,788 shares of the Company's Common Stock had been donated by the Company to Comed Electronics Corporation (a newly-organized subsidiary which subsequently changed its name to Anton-Imco Electronics Corp.) which company received the net assets of Anton-Imco; of these shares, 53,333 shares received in exchange for 40,000 shares of Anton-Imco common stock are held in the treasury of the Company. This transaction has been accounted for as a pooling of interests and, accordingly, the net assets of Anton-Imco have been carried forward at their book amounts and the results of its operations, commencing from January 1, 1957, have been included with the consolidated results of operations of the Company and its other subsidiaries."

Excerpt From Hathaway Proxy Statement
(Plaintiffs' Exhibit 17)

Note C—Merchandise Inventories:

"No physical inventories were taken by the companies as at June 30, 1960 and 1961 (other than one subsidiary at June 30, 1961). The merchandise inventories at such dates applicable to companies which did not take physical inventories were estimated by the management by adding purchases, direct labor and factory overhead to the merchandise inventories at the beginning of the period, and deducting therefrom estimated cost of goods sold.

"It is impractical to segregate estimated inventories at June 30, 1961 as to raw materials and manufacturing supplies, goods in process and finished goods."

SUPREME COURT, U. S. 880

FILED

JAN 4 1974

MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

THE LIONEL CORPORATION,
Petitioner,

against

REPUBLIC TECHNOLOGY FUND, INC.,
Respondent.

THE LIONEL CORPORATION,
Petitioner,

against

THE NEW ENGLAND INDUSTRIES, INC.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENTS REPUBLIC TECHNOLOGY FUND, INC. AND THE NEW ENGLAND INDUSTRIES, INC., IN OPPOSITION

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LESLIE LUPERT
Of Counsel

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IN THE

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THE LIONEL CORPORATION,

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REPUBLIC TECHNOLOGY FUND, INC.,

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THE LIONEL CORPORATION,

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against

THE NEW ENGLAND INDUSTRIES, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENTS REPUBLIC TECHNOLOGY FUND, INC. AND THE NEW ENGLAND INDUSTRIES, INC., IN OPPOSITION

Opinions Below

The opinion and concurring opinion of the Court of Appeals (Pet. App. 1a-25a)* are reported at 483 F.2d 540, 553 (2d Cir. 1973). The opinion of the trial court (Pet. App. 27a-55a) is reported at 345 F.Supp. 656 (S.D.N.Y. 1972).

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* References with the suffix "a" are to the appendix to the petition for certiorari.

Jurisdiction

The judgment of the Court of Appeals was entered on July 17, 1973. On July 30, 1973, petitioner filed with the Court of Appeals a "Petition for Rehearing With Suggested Rehearing In Banc". On September 6, 1973, the Court of Appeals denied the motion for rehearing. No active Circuit Judge requested that a vote be taken on the question of a rehearing in banc, and the balance of the petition for rehearing was denied on September 6, 1973. The petition for a Writ of Certiorari was filed on December 5, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1), and respondents make no objection to the petition on jurisdictional grounds.

Question Presented

Whether this Court should review a decision of a Court of Appeals which neither conflicts with any other decision nor makes new law, where the principal issues decided by the Court of Appeals are whether items in an interim financial statement were misleading as a matter of law, and where there has been no final judgment.

Statute and Rules Involved

The pertinent statutes and rules are adequately set forth in the petition.

Statement

The facts are well stated in the unanimous* Second Circuit opinion, which the Court has before it in the petition (2a et seq.), and need not be restated at length here.

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* Judge Mulligan, concurring, differed on one point, which is not raised by petitioner in this Court.

The Second Circuit had before it for review a non-jury trial on issues of liability.* Respondents were investors in the stock of petitioner The Lionel Corporation ("Lionel"); their claims involved violations of the Federal securities laws and breaches of contracts to register stock, which arose under State law.

Respondents in 1960 and the spring of 1961 purchased about $1,500,000 of unregistered stock from Hathaway Instruments, Inc. ("Hathaway"), a corporation which merged into Lionel in the fall of 1961. Hathaway had undertaken certain registration obligations, which were later assumed by Lionel. In addition, in the merger agreement, Lionel undertook to file, by October 15, 1961, a registration statement to cover respondents' unregistered stock.

To induce consent to the merger, Lionel issued in a proxy statement unaudited interim financial statements for the six months period ended June 30, 1961, which showed a combined pro forma profit of $245,000, or $.08 per share, and a six months' loss for Lionel of $84,000, or $.06 per share. Lionel also filed a registration statement with the Securities and Exchange Commission, which included the same interim statement. The stockholders of Hathaway approved the merger in October and it became effective in November. Respondents exchanged their Hathaway shares for Lionel shares.**

The very next month, Lionel recorded adjustments, allocable to the entire year, which reduced profits for the year by $2,221,659. These were charged against inventory, sales returns and allowances, research and development and other categories. None of them was reflected in the interim statement submitted to respondents and other investors and filed with the SEC.

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* The District Court ordered a split trial; issues of damages have not yet been tried.

** Respondents held Hathaway common stock and received from Lionel 3¾% convertible preferred stock, but this difference was not material to the issues in the case.

The combined six month pro forma profit of almost a quarter million dollars turned, after the merger, into a loss for the year of $1,898,609, plus $633,668 of special charges, or a loss for the year of over $2.5 million. The six months' earnings per share of $.08 profit turned into a year's loss of $1.71 per share.

Lionel did not disclose that an important recently acquired division (Anton-Imco) had been losing money heavily in the first six months. The $188,842 loss in the Anton-Imco division was not disclosed by the consolidated interim statement; no adjustment had been made to the $998,000 of goodwill carried for Anton-Imco, which would have been charged against profits; the goodwill figure itself was buried in consolidated figures and no uncertainty about the division had been indicated in the notes to Lionel's financial statements.

The explanation which Lionel's auditor and expert witness gave for not writing down goodwill was that Anton-Imco was engaged in the development of a "new machine—I believe it was a money sensor, a money changing device—and based on all the information that was available at that time the prospects for success seemed very reasonable." The auditor relied exclusively on this product to justify Lionel's treatment of the Anton-Imco goodwill.

The notes to the consolidated interim statements themselves stated, however, for Anton-Imco:

> "This company recently designed and developed a currency recognizing device, several prototype models of which have been built up to this time. The device has not yet been marketed and there is no assurance at this time as to whether it will be a profitable item."

The District Court accepted the auditor's testimony; the Second Circuit held, as a matter of law, that Lionel's treatment of Anton-Imco goodwill was misleading.

The Court of Appeals also held that Lionel had had the burden of going forward to justify its treatment of two other items in the interim statement, on which Lionel had not justified its treatment, and remanded for further findings and proceedings consistent with its opinion.

The Court of Appeals also remanded for further findings on materiality, scienter and certain facts involved in the contract causes of action, and stated that, on remand, the District Court should deal with Lionel's affirmative defenses, which it had not yet reached.

Issues of damages have not yet been adjudicated. The registration statement had not become effective with the interim figures referred to, but was amended, and only became effective much later, and then only for a short time.* Respondents' investment was virtually wiped out, and respondents have alleged out of pocket losses of over $1,250,000.

POINT I

The petition should be denied because no important or novel issue of law is raised, and no conflict with any other circuit or case is claimed or shown.

Lionel does not seek review of any novel or important question of law; it cites no conflicts with the decision of any other circuit, or of any other court. At bottom, what Lionel complains of is that it lost the case below. The Court of Appeals for the Second Circuit applied precedents of long standing to the financial statements issued by Lionel, held that three items were misleading as a matter of law, on the record below, and remanded for further findings on the issues of liability, and further proceedings consistent with its decision, presumably including a hear-

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* Another issue below was Lionel's failure to comply with a best efforts obligation to maintain shelf registration for 24 months.

ing on damages and resolution of affirmative defenses, which have not yet been reached (483 F.2d at fn. 13, p. 553).

Even if the unanimous decision of the Court of Appeals had been wrong—as it palpably was not—this case would have been inappropriate for certiorari. As Stern and Gressman put it:

> "It has been reiterated many times that the Supreme Court is not primarily concerned with the correction of errors in lower court decisions. 'The fact that a case may have been wrongly decided as between the parties is not, standing alone, enough to assure certiorari, nor, for that matter, is the fact that a case may have been rightly decided in itself enough to preclude certiorari.' Mr. Justice Harlan, *Manning the Dikes,* 13 Record of N.Y.C.B.A. 541, 551 (1958). The Court's aim, rather, is to resolve the conflicts among the lower courts and to determine questions of importance." Stern and Gressman, *Supreme Court Practice* (4th Ed. 1969), p. 178.

Lionel complains basically that the Second Circuit reversed findings of the District Court (Bonsal, J.) as clearly erroneous. Lionel concedes, however, that the Court of Appeals applied a correct standard of review. Lionel also does not dispute the Second Circuit's conclusion that full disclosure in interim financial statements, issued to the public and governed by the Securities Exchange Act of 1934 and Securities Act of 1933, is required by *Kaiser-Frazer Corp.* v. *Otis & Co.,* 195 F.2d 838 (2d Cir. 1952), *cert. denied,* 344 U.S. 856 (1952). The petitioner cites no authority to the contrary, or any reason to distinguish that twenty-year-old Second Circuit precedent, other than Lionel's displeasure at the result.

No basis has been shown to take seriously a claim that this case is worthy of certiorari. To this must be added the consideration that no final judgment has been reached because further findings are required on liability and because

neither affirmative defenses nor the amount of damages has yet been decided. Certiorari will normally not be granted to a case in this posture "in the absence of some exceptional reason." Stern and Gressman, *op. cit.*, p. 180. No such reason has been shown by Lionel.

POINT II

Lionel's arguments lack merit.

Lionel launches a lengthy attack on the Second Circuit's holding that as a matter of law Lionel misled investors as to the value of its newly acquired Anton-Imco subsidiary.

The facts are that Anton-Imco was losing money heavily ($189,000 in the first six months of 1961), that Lionel carried on its books almost a million dollars of goodwill for that division, that respondents' accounting expert gave his opinion that the losses required a writedown of the division's goodwill, thereby reducing Lionel's profits, that Lionel's expert had to admit that because of the losses a writedown of goodwill should have been considered but said that this factor was outweighed by a reason which Lionel's own financial statement showed to be spurious (483 F.2d at 546), and that investors were kept in the dark about the division's uncertainties by a combination of consolidated accounting methods and non-disclosure in the notes. The issue was discussed at length by the Second Circuit (483 F.2d at 546-48, 550-51), when it unanimously reversed the District Judge, who had no more facts to go on than did the Court of Appeals, but who implicitly condoned what can only be called an outrageous act of concealment and misrepresentation.

Lionel now seeks to justify its treatment by belatedly arguing that it is now permissible to amortize goodwill over a forty-year period.* The argument is that only one-

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* Lionel first raised this argument in its petition for rehearing to the Circuit Court, which was denied.

fortieth of goodwill should have had to be written off in 1961. The requirements on writing down goodwill where operating losses occur are set forth in the Court of Appeals opinion in this case, and in Accounting Research Bulletin 43. In 1970, APB Opinion No. 17 took the position that goodwill should be written down even in a profitable company, over a period that "should not . . . exceed forty years." Lionel extrapolates from this an argument that a company need never write down its goodwill by more than one-fortieth each year, regardless of the actual operations of the company. This is simply not what the Accounting Principles Board opinion states nor what common sense dictates. Anton-Imco suffered a large loss for the first six months of 1961 and the interim statement was materially misleading in failing either to write down the goodwill by a significant amount, or to note some uncertainty with respect to the overall operation of the company.

Lionel also complains that the Court of Appeals erred in placing on Lionel the burden of going forward with evidence to explain its treatment of raw material price variance in its toy and train division, for which Lionel made an adjustment for the twelve months of $140,000, and for which Lionel made no adjustment at all in the interim six months statement. The Court of Appeals excused Lionel from allocating to the interim statement any part of its year-end adjustment for inventory obsolescence in the toy and train division ($262,830), on the theory that obsolescence is recognized when sales are made and that the District Court had found that sales were made at Christmas time, despite testimony by one of respondents' expert witnesses that the key time for determining a toy manufacturer's sales was the March toy show. The Court of Appeals did not hold this finding clearly erroneous, but noted that even if all Lionel's sales were made at the end of the year "it would seem fairly certain that manufacturing and raw material purchases must have occurred

well before June 30, even in the Christmas seasonable toy and train division" (483 F.2d at 548). Lionel produced no records or testimony on its purchases or sales and claimed, both during discovery and trial, that it could not locate them (Trial Transcript, p. 552). The Court of Appeals held only that on such a record Lionel should have been required to go forward with evidence.

The other burden of production item may be analyzed similarly; this Court is referred to the Court of Appeals opinion (483 F.2d at 549).*

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a Writ of Certiorari should be denied.

Dated: New York, New York, December 28, 1973.

Respectfully submitted,

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Of Counsel

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* Lionel also complains of the application of the securities laws but gives no reason why any such application here was incorrect. It also refers to the age of the case, and mentions that the case was at one point, some years ago, abandoned by predecessor counsel for respondents, but fails to mention that this very lawyer had been retained by Lionel, without respondents' knowledge or consent, and that the lawyer thus retained by Lionel was the one who abandoned the case, without respondents' knowledge or consent. The point was alluded to by the Court of Appeals (483 F.2d at fn. 13, p. 553). The prior abandonment was without prejudice to respondents and the case was thereafter continued and properly prosecuted by present counsel.